

Planning for the Terminally Ill in 2012

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"Life is pleasant. Death is peaceful. It's the Transition that's Troublesome."

Jimi Hendrix

Since 2001 my speeches have included a laugh line on being careful about who holds your Medical Directive. As we near the end of 2012, the line is no longer funny. Assume a terminally ill client's estate is valued at \$10 million. His doctor comes to his children and tells them he could keep dad alive for a few days into 2013. Given that those few days could cost the family \$4.8 million in additional estate taxes, how often would the response be: "Doc,..... could you work with me here?"

Going from a estate which is not taxable in 2010-2012 to one in which the estate tax rate could be as high as 60% (assuming Congress fails to act on the transfer tax) after 2012 will create some rather macabre and unsavory choices for family members. Some terminally ill clients may decide to take matters into their own hands.

While the tax impact is larger for affluent clients, there are also a multitude of planning ideas that less wealthy terminally ill clients should consider.

Chaos And Uncertainty. Unless Congress acts either in 2012 or retroactively in 2013, on January 1, 2013, most of the terms of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Act") automatically expire. These expirations will substantially increase the transfer tax cost on the passage of wealth by affluent taxpayers and provide for a host of income tax increases.

Look at the transfer tax issue in its most simplistic form. Assume the following estate values for an unmarried client, in a state without a decoupled state death tax. Assume Congress fails to change the federal transfer tax laws:

Taxable Estate	Estate Tax Liability			% to Heirs	
	Bequest in 2012	Bequest in 2013	Difference	2012	2013
\$2,000,000	-0-	\$435,000	\$435,000	100%	78%
\$3,000,000	-0-	\$945,000	\$945,000	100%	69%
\$5,000,000	-0-	\$2,045,000	\$2,045,000	100%	59%
\$10,000,000	\$1,708,000	\$4,795,000	\$3,087,000	83%	52%
\$20,000,000	\$5,208,000	\$10,654,200	\$5,446,200	74%	47%

Many advisors believe that Congress will enact larger exemptions and lower tax rates than those which will automatically apply in 2013. While that is a possibility, the current political environment makes passage of permanent reform less likely. The adoption of permanent transfer tax reform will probably only occur as a part of a reform of the entire Internal Revenue Code. If Congress could not come to agreement on even moderate cuts in the increasing deficit, how likely is it that they will come to agreement on permanent reform of the entire tax code? Will they continue the politically expedient approach of just deferring the hard decisions for a few more years?

Here are a few perspectives that terminally ill clients and their advisors should bring to the planning process in 2012:

- (1) For affluent terminally ill clients, the looming tragedy of death can be exacerbated by the uncertainty of the taxes their family may pay upon their passing.
- (2) Recognize that the transfer tax rules will change in 2013, either automatically or by Congressional action. We just don't know what the post-2012 transfer tax exemptions, tax rates and other rules will be. Unfortunately, with 2012 being a Presidential and Congressional election year, there is a very strong likelihood that we will not know what the post-2012 transfer tax rules are until sometime into 2013. How the elections turn out will largely determine what the tax rules look like in 2013 and when any changes will be adopted.

At best, any tax legislation will be adopted at the last minute, as was done in 2010. Any last minute legislation is unlikely to be permanent. Moreover, if adopted at the end of 2012, most planners will not have the time to adequately study the law, advise clients and then implement any plans. Remember that the 2010 Tax Act became law on December 17, 2010 – two weeks before the end of the year and in the middle of the Christmas season.

- (3) Because of the anticipated lack of Congressional legislation in 2012, clients may have to make decisions in 2012 without knowing what the income tax and transfer tax rules are in 2013. Effectively, they will have to plan in a vacuum of information, forcing them to “*Plan for the Worst and Hope for the Best*” – and resulting documents will have to be flexible enough to deal with all of the expected and unexpected possibilities.
- (4) It is unlikely that Congress will retain the large federal gift tax exemptions and/or low transfer tax rates that are currently in place. Income taxes over time will probably increase. In general, asset values are beginning to increase as we move out of the recession. The section 7520 interest rates that lie at the heart of many of the tax reduction strategies will increase. Inflation may return once the economy recovers. For a tax-adverse, affluent client with a limited life expectancy, all of the above factors favor making significant transfers of assets in 2012.
- (5) At least through the end of 2012, many of the “norms” of estate planning advice will be turned on their head. For example, terminally ill clients without a taxable estate may want to develop plans to purposely increase the value of their assets if they are expected to pass in 2012, giving their heirs a larger step up in basis.

Clients Who Will Pass In 2012. If you know a client will pass in 2012, there are concrete recommendations you can provide, including the following:

Gifts to the Terminally Ill. Gifting to a terminally ill spouse who is expected to pass in 2012 can make sense.

Planning Example: Assume a married client is terminally ill and will clearly pass in 2012. The healthier spouse can transfer assets to the terminally ill spouse whose dispositive documents establish a testamentary Exemption Trust. To reduce the exposure to a step transaction argument, make the gift as early as possible. Use of this approach can result in:

- Elimination of future estate taxes when the surviving spouse passes. The first to die spouse gifts up to \$5.12 million to an Exemption Trust, excluding from future transfer taxes both the asset's estate value and future appreciation, while the surviving spouse retains his or her own exemption (whatever it may be when they pass);

- The Exemption Trust can provide for discretionary distributions of income and principal among a broad group of heirs who may be in varying income tax brackets; and
- Asset protection can be provided for the beneficiaries (e.g. when the widower marries a woman the age of his children).

But what happens to the basis of the assets gifted by the spouse? IRC section 1014(e) provides: “..... if (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.” The IRS has stated (see: PLRs, 9321050, 9026036, 2002120051 and 200101021) that this code section also applies to bequests in trusts for the original donor. However, the donee/terminally ill spouse could provide for a special bequest of the gifted assets for the benefit of other heirs (e.g., the couple's children or a trust for their benefit).

Charitable Gifts. Many clients make charitable bequests, but if a client dies in 2012, there may be no taxable estate (i.e., because of the high estate exemptions) or income tax benefit (i.e., because the charitable deduction is not reflected on the client's personal income tax return) from making the charitable bequest. To obtain income tax benefits, make the charitable gift before the client's death and take advantage of the charitable income tax deduction to reduce the client's income taxes. Part of this plan might include accelerating income into the client's last income tax return to take advantage of the charitable contribution (e.g., a ROTH conversion).

Planning Example: Replacing a \$50,000 charitable bequest with a 2012 gift could save up to \$17,500 in federal income taxes (i.e., \$50,000 times the 35% top federal income tax rate in 2012).

Traps: Make sure the dispositive documents are changed to remove the charitable bequests, or the charity might have a claim against the estate. Also make sure the client can fully use the charitable income tax deduction (e.g., charitable deduction limitations, AMT or itemized deduction limits could reduce the tax benefit).

Exemption Trusts. Given the uncertainty of Congressional tax actions in the next few years, clients who will pass in 2012 should strongly consider the use of Exemption Trusts rather than outright bequests. Why? The use of an Exemption Trust allows for maximum asset protection and tax protection during these times of uncertainty and effectively locks in the benefit of the 2012 transfer tax exemption.

Planning Example: A married couple each own \$2.0 million worth of assets. The assets are growing at an annual rate of 3%. Assume the husband died in 2012 and passed all of his assets outright to his wife who died in 2017. The husband's death in 2012 incurs no federal estate tax. Under current law, an estate tax of \$1.85 million would be due on the wife's estate value of \$4.64 million. If the husband's entire estate had been placed in an Exemption Trust, the total assets would have the same value, but the estate tax liability on the wife's death would be \$1.26 million less.

Portability vs. Exemption Trusts. While portability can provide benefits to a client, portability as a planning tool has serious problems, including:

- (1) Will Congress reinstate portability in 2013? Or will Congress fail to act and let portability die? If you have other options, why would you rely upon something scheduled to terminate at the end of 2012?
- (2) Even if portability is reinstated after 2012, what will be the portable amount allowed to the surviving spouse? Will it be the unused transfer tax exemption available in 2012 (i.e. up to \$5.12M) or the estate tax exemption permitted after 2012, reduced by the exemption used when the first spouse died?

For example, if the portable exemption becomes \$2.5 million and the deceased spouse had a \$3.0 million estate, there might be no portable exemption.

- (3) Portability does not extend to generation skipping tax exemptions, while an Exemption Trust can utilize the first to die spouse's GST exemption.
- (4) Portability does not increase in value, while future appreciation in an Exemption Trust is not subject to further transfer taxation.
- (5) The assets placed in an Exemption Trust can be protected from creditors, including divorce and probate claims of the next spouse (e.g., dower, curtesy, years support or claims in intestacy).
- (6) An Exemption Trust can permit income and principal to be "sprayed" to the surviving spouse, descendants and others, without further transfer tax issues. By having the Exemption Trust distribute income to taxpayers in lower income tax brackets than the surviving spouse (e.g., a child getting married), more after-tax dollars can be passed to heirs, while still providing a pool of assets to provide support for the surviving spouse.
- (7) If a surviving spouse remarries and the second spouse pre-deceases, the unused exemption of the second deceased spouse becomes the new portable exemption. By using an Exemption Trust at the first spouse's death, you can obtain the benefit of both deceased spouses' exemptions.

Recommendation: The bottom line for any married client expected to pass in 2012 is to create an Exemption Trust in lieu of hoping that portability will provide as much benefit after 2012.

Trap: Even though the federal transfer tax rules permit portability, upon the surviving spouse's passing unexpected state estate taxes could arise in "uncoupled states" because:

- (1) The state has not adopted a statute permitting portability of a deceased spouse's state death tax exemption, and/or
- (2) The state's death tax exemption is less than the federal exemptions.

State Transfer Taxes. Even though clients dying in 2012 may not owe any federal estate tax, advisors should keep an eye on the ever changing landscape of state transfer taxes. Many states have "decoupled" from the federal estate tax and have estate tax exemptions that are lower than the federal exemptions, resulting in the potential imposition of state death taxes even when there is no federal estate tax due.

Planning Example: Gifting assets can reduce the state estate taxes in decoupled estates. A client is dying with an estate of \$4.0 million. Assume the estate exemption in her state is \$1,000,000, with an effective state death tax rate of 9%. Assume the client gifted \$3.0 million of her estate to her heirs. The gift in 2012 would save her heirs approximately \$270,000 in state death taxes.

Trap: If the client is domiciled in Connecticut or is gifting Connecticut based assets, make sure the gift is not subject to a Connecticut gift tax. Connecticut remains the only state in the United States to impose a gift tax. The Tennessee legislature recently eliminated the Tennessee gift tax retroactively to January 1, 2012. Louisiana (effective July 1, 2008) and North Carolina (effective January 1, 2009) have both eliminated their gift taxes.

Planning for a Higher Basis.

Planning Example: Because of the recent economic downturn, many terminally ill clients own assets that have lost significant value. Part of the planning for such clients should focus on retaining the higher basis for heirs. Assume a terminally ill married client owns an asset with a basis of \$500,000 and a fair market value of \$200,000. If the client dies, the asset's basis will step down to its fair market value, resulting in the termination of the tax benefit of the loss in the value of an asset. Instead, the terminally ill client could gift the asset to an heir. If the heir subsequently sells the asset for a value from \$200,000 to \$500,000, no taxable gain or loss will be reported on the sale. See

Treasury Regulation section 1.1015-1(a).

Planning Example: Assume that in 2012, a terminally ill client owns 40% of a business having a fair market value of \$4.0 million. The estimated valuation adjustments are 30%. The client's sole heir owns the remaining 60% of the business. The client's remaining assets are \$200,000. When the client dies, the tax basis in the 40% business interest would become \$1,120,000. Assume instead, the client purchased a 15% minority interest from the heir for a note. At the client's death, his 55% interest is worth at least \$2.2 million (perhaps more if a control premium is applied). The note and remaining assets would produce a non-taxable estate of \$1,980,000, while providing a step up in basis for the 55% interest to \$2.2 million. Assuming the heir sold the business after the client's death, the new step-up in basis would save up to \$216,000 in capital gain taxes, assuming a 20% applicable rate. However, there could be an income tax cost to the heir who sold the 15% interest.

Does it make sense to bust strategies that were designed to discount values if the client has a non-taxable estate in 2012?

Planning Example: Years ago a client created a Family Limited Partnership and the donor retained a majority ownership interest. Should the terminally ill client terminate the FLP before year end and receive assets from the FLP equal to the higher fair market value of the controlling interest owned in the FLP? The basis step-up for the liquidated assets in the estate would generally be valued at a value higher than what the interest in the FLP would have been valued. As long as there is no additional estate tax liability, this approach would appear to make sense.

Planning Example: Years ago a client created an FLP. The document has not been reviewed or revised since its execution. The client has been giving away limited partnership units of the FLP for years to family members. Unfortunately, the client's control over the FLP clearly violates the current case law and could result in the gifted assets being included in the donor's taxable estate pursuant to IRC section 2036. Assume the client's total estate, plus the current value of the gifted assets is well below \$5.0 million. In preparing the federal estate tax return, the advisor might show that the retained control violated IRC section 2036 and pulled the gifted FLP units into the taxable estate. Why? Because the basis of the gifted FLP units will step up to their fair market value and the internal basis in the FLP assets can also step up.

If the donor client intends to gift an asset with significant unrealized gain, it may make more sense to have the donor sell the asset and then gift the cash. The payment of the capital gain tax and any ordinary income taxes further reduces the taxable estate of the donor. Moreover, if the donee assumes responsibility for the payment of the tax on the appreciated gain, it effectively wastes a part of the donor's transfer tax exemption or annual exclusion.

Planning Example: A donor wants to make a gift of \$2.1 million in marketable securities to her children in 2012. The stocks have a basis of \$100,000. The donor's and donees' effective tax rate is 20%. If the donor sells the stock, her taxable estate is reduced by the \$400,000 paid in income taxes and at a 55% estate tax rate saves the heirs \$220,000. If the donor gifts the stock, the donees will pay the \$400,000 tax, making the effective benefit of the gift only \$1.7 million.

Trap: With the shrinkage in 2012 in the difference in tax rates for gift taxes and income taxes (including capital gains taxes), advisors who are recommending gifts of low basis assets should calculate when the transfer tax savings of the gift overcome the expected income tax cost of a carryover basis. If the donor dies proximate to the time of the gift with a non-taxable estate, the donees may question the loss of a step-up in basis.

Clients Who Will Pass After 2012. If the client is expected to pass after 2012, there are many tax planning opportunities and traps that need to be considered, including:

Estate Tax Clawback on Gifts. Clawback is essentially the question of whether a client who makes non-taxable gifts before 2013, will pay a transfer tax on those gifts when the client dies after 2012. There is significant disagreement among commentators on whether current law would eliminate the potential for clawback. Whether or not clawback is an issue, the general consensus is that Congress will fix the issue in new legislation, particularly if the IRS acts aggressively to impose estate taxes on previously non-taxable gifts. While there are current proposals designed to mitigate the impact of clawback (e.g., H.R. 3467), there is no certainty on whether anything will be passed and if something does pass, what the form of the new legislation will be.

Impact of Prior Gifts on the Estate Exemption. Even if Clawback is fixed, large gifts before 2012 could create an unexpected estate tax impact after 2012. First, the unified transfer tax system provides that the use of a taxpayer's gift tax exemption during life reduces the available estate tax exemption at death. Assuming Congress addresses the issue, does it exclude all prior non-taxable gifts from the computation of the estate tax, or does it effectively apply the prior non-taxable gifts against the client's estate exemption? If the second approach is adopted, it could mean that a client's estate exemption may be substantially reduced or eliminated in the future if significant gifts were made before 2013. Second, the inclusion of prior gifts in the computation of estate taxes results in the increase in the estate tax rate on the assets remaining in the taxable estate.

Planning Example: Assume a terminally ill client with a \$3.5 million estate is considering making gifts. Assume Congress fails to act on transfer tax reform and there is no clawback. The following would be the highest transfer tax payable under various gifting scenarios

<u>Gift in 2012</u>	<u>Assets in Estate</u>	<u>Estate Tax in 2013</u>
\$3.5M	-0-	-0-
\$2.5M	\$1.0M	\$540,000
\$1.5M	\$2.0M	\$1,090,000

The point of these calculations is that keeping the assets in the client's estate will increase the overall transfer tax and effectively encourages clients to consider maximizing their gifts in 2012.

Making Taxable Gifts in 2012. One of the issues which affluent clients should address is whether they should take advantage of the lower transfer tax rate of 35% in 2012 or wait to see what the transfer tax will be when they die. While the normal advice is to defer transfer taxes as long as possible, the potential 20% swing in transfer tax rates, the low section 7520 rates, and the increasing value of assets as we move out of recession (and possibility into inflation) all encourage affluent clients to consider incurring taxable gifts in 2012. This is particularly true for a client with a limited life expectancy.

Planning Example: Assume an unmarried widow has a \$10 million taxable estate. She has an adequate pension and social security income stream to properly support her. She is expected to pass soon after 2012. Assume she made a net gift (see discussion below) of her entire estate in 2012. The gift tax paid by the donees would be \$1.3 million. If she passed within three years of the gift, the gift taxes will be pulled back into her taxable estate and be paid by the donees.

Trap: In considering a taxable gift to a non-spouse, one of the considerations should be the impact of the donee dying within a few years of the transfer. While IRC section 2013 provides an estate tax credit for estate taxes paid by a previous decedent/owner, there is no comparable benefit for gift taxes paid. Potentially, the combination of the gift tax on the initial gift coupled with the estate tax liability upon the donee's death could eliminate the tax benefits of the planning opportunities discussed in this

article. It may make more sense to gift to a trust in lieu of a direct gift (particularly to an heir with significant health issues or who has no descendants) and give the intended initial donee a lifetime interest in the trust. The trust could provide potential estate tax savings to the donee's heirs and asset protection to the donee.

Prepaying transfer taxes not only provides for potentially lower effective transfer tax rates, it also moves future appreciation on the asset outside the donor's taxable estate and, if the donor survives the gift by three years, removes the amount of the gift tax from the taxable estate. As we move out of the recession and values start increasing (whether because of inflation or true value increases), the elimination of estate taxes on future appreciation could be a significant issue.

Hoarding Cash. One of the reasons that 2012 gift planning should start early is the need for many clients to start hoarding cash or otherwise obtain liquidity to pay for any gift taxes which will be due on April 15, 2013. The amount of cash the client can accumulate by April 15, 2013 may directly determine how much they can gift in 2012.

Planning Example: Assume an unmarried client owns a family business worth \$40 million. Assume a 40% discount is applied to the gift of a minority interest in the business. He wants to pass 49% of the business to children working in the company, effectively at a taxable value of \$11.8 million. If the client has all of his gift exemption available, he would need to hoard about \$2.4 million to pay the gift taxes. The less cash he expects to be able to accumulate by April 15, 2013, the less he should gift before the end of 2012. Assuming no growth in the value of the company and 100% is transferred at death, the estate tax savings on the 49% transfer could be \$10.8 million (i.e., \$40 million multiplied times 49% times at a 55% tax rate, with no discount applied). If the donor survives the gift by three years (i.e., the gift taxes paid are not included in the taxable estate), there is an additional tax savings from removing the \$2.4 million in gift taxes from the taxable estate.

Portability – Use it or Potentially Lose it? A married client passes before 2013 and fails to use all of his or her available federal estate tax exemption. The unused part of the exemption carries over to the surviving spouse. As noted previously in this article, even if portability is reinstated after 2012, it is unclear how it will be calculated. Affluent clients should consider using not only their own gift tax exemption in 2012, but also any portable exemption of a predeceased spouse. Better to use the available portable exemption in 2012 than risk losing it in 2013.

Planning Example. A surviving husband has a \$20 million estate and has not used any of his gift exemption. His wife died in 2011 and did not to use \$3.0 million of her estate exemption. If the husband gifted \$8.0 million to his descendants in 2012, the transfer would save his descendants up to \$3.85 million (i.e., \$7.0 million times 55%) in estate taxes (ignoring any appreciation).

Transfer Tax Planning for the Terminally Ill.

Annual Exclusion Gifts. Terminally ill affluent clients should consider maximizing their annual exclusion gifting in 2012 and in early 2013, especially if the gift is treated as an advancement of a bequest under the will.

Planning Example: A terminally ill client's will provides for 20 special bequests of \$20,000 each to friends and family, with the balance going to nieces and nephews. The will provides that the residue pays any estate tax. Have the client make the \$400,000 in transfers during life as annual exclusion gifts in 2012 and early 2013. Assuming a taxable estate, converting the bequests to annual exclusion gifts saves the nieces and nephews \$164,000 to \$240,000 in estate taxes (i.e., assuming the effective

estate tax rates in 2013 are between 41% and 60%).

Trap: If advancement gifts are made, revise the dispositive documents to eliminate those bequests or have a provision in the documents that treats the gifts as an advancement of the bequest.

Planning Example: The annual exclusions should not stop with just special bequests under the will. Particularly if the annual exclusion gifts are of cash, the client should consider pre-funding residuary bequests using the annual exclusion. For example, assume an unmarried terminally client with a taxable estate passes her residuary estate equally to her eight nieces and nephews. Making annual exclusion gifts to the heirs in 2012 and 2013, could save the heirs between \$72,800 (i.e., \$13,000 times 8 heirs times 2 years times 35%) and \$124,800 (i.e., \$13,000 times 8 heirs times 2 years times 60%).

In TAM 199941013 and PLR 200602002, the IRS agreed that a donor's advance payments of tuition were excluded from gift tax pursuant to IRC section 2503(e) if the pre-payment was not refundable. The rulings offer an opportunity for clients (especially those who may die before the tuition comes due) to further reduce their taxable estate.

Preserve the \$5,120,000 Exemption for Heirs. Clients should also consider the impact of the 2013 changes on their heirs. Treat the high exemptions in 2012 as not just a planning opportunity for the client, but also as a way to grow assets in the future for heirs, without incurring any additional transfer taxes. Point out to clients that their bequests and any post-transfer increases in value to descendants will sit on top of the descendants' own assets – effectively being taxed at the highest applicable tax rate.

Planning Example: Assume a terminally ill unmarried client with a \$4.0 million estate has a son with 4 children and a daughter with no descendants. Assume the daughter died ten years later, when her share of the inheritance was worth \$3.4 million. Bequeathing assets to a generation skipping trusts provides a number of benefits, including:

- Saving the family up to \$1.87 million (i.e., \$3.4 million times 55%) in estate taxes (assuming Congress fails to act). Post-2012 changes in the estate exemption and tax rates should have no tax impact on the passage of the trust's wealth.
- The assets stay in the family bloodline (e.g., they will not pass to the daughter's husband, who then passes them to a second wife).
- The children could be given Limited Powers of Appointment to decide how and when the assets of their respective trusts pass to their parent's descendants and/or charities.
- With proper terms, the trust can protect successive generations of descendants from creditors and divorcing spouses.

Planning for future transfer taxes is particularly important for unmarried couples.

Planning Example Assume a client with a \$4.0 million estate has lived with a partner for 20 years, but is not married. If the client dies in 2012, he can pass all his assets to an Exemption Trust and be assured that no estate taxes will be imposed upon the partner's death. In the alternative, if the estate passes directly to the partner, up to \$1.5 million in estate taxes may be due when the partner dies after 2012 (ignoring any appreciation). The use of an Exemption Trust also permits a reduction or an elimination of partner benefits from the trust if certain conditions occur, such as the partner getting married. In addition, by using an Exemption Trust, the first to die partner could control the ultimate disposition of the trust assets (e.g., passing them to children from a prior marriage).

Gift-Splitting and Gift Tax Inclusion. While gift taxes paid on gifts made within three years of death are included in the donor's estate, IRC section 2035(b) does not include gift tax payments in the donor's estate to

the extent that the gift tax was paid by the decedent's spouse pursuant to a gift-splitting arrangement. The relevant tax policy is that there is no incentive to restore the decedent's estate pursuant to IRC 2035 because no assets were removed from the estate by the gift tax payment.

Planning Example: If one spouse is in poorer health than the other, consider making a gift splitting election and have the healthier spouse (assuming he or she has the available funds from their own resources) pay the total gift tax (See: PLR. 9214027). This eliminates the chance that the gift tax will be included in the unhealthy spouse's taxable estate. What if neither spouse is in great health? Consider gift splitting and having each spouse pay half the gift tax, increasing the chance that at least one of them will survive beyond the three years.

Net Gifts. Many donors are uncomfortable with the potential further depletion of their remaining estate by gifts taxes, or penalties and interest from underreported gifts. This should never be an impediment to making a major gift. Consider the use of a "net gift." A "net gift" is a gift in which the donor, as a condition of the gift, requires the donee to pay the gift tax. The gift's value is reduced by the gift tax to be paid by the donee because the donee's payment of the gift tax is considered a sale, not a gift, by the donor. The amount of the gift tax (and the reduction in the value of the gift) is determined by a formula of: the tentative gift tax divided by the sum of one plus the rate of tax. In Revenue Ruling 80-111 (1980-1 CB 208), the IRS noted that any state gift taxes which were assumed by the donee can also be taken into account to reduce the gift value.

Planning Example: Assume an unmarried donor who has retained all of his gift exemption, makes a \$10 million gift in 2012 to a donee, and the donee is obligated to pay the gift tax on the transfer. The gift tax on the "net gift" is \$1,265,185 - an effective transfer tax rate of 12.65%.

Trap: Make sure the donor and donee both sign a comprehensive document that fully documents each of their responsibilities for the applicable gift. For example, if the donor dies within three years of the gift, is the donee liable for payment of the additional estate tax from the inclusion of the gift tax in the donor's taxable estate?

Discounting Family Debt. As a consequence of estate planning and other family planning, many clients have created intra-family debt (e.g., an installment sale of a family business interest to an income defective trust). Rather than leaving the debt in the estate of the older generation, clients should consider a forgiveness of the debt on a net gift basis – effectively treating a net gift arrangement as a discounted pay-off of the note. Here's the basic question to ask the reluctant client: "*If you could satisfy a debt for a fraction of its face value, while eliminating a potential estate tax of up to 55% of the debt, why would you NOT act?*"

Planning Example: Assume an unmarried client has completed a sale of a real estate LLC using a \$10 million note to a trust for his children. The client agrees to forgive the note if the trust will pay the gift tax. Assuming the client has not used any of his gift exemption, the gift tax on the net gift value would be roughly \$1.3 million. The trust could obtain a loan from a commercial lender to cover the gift tax liability, or borrow the funds from the donor.

Trap: The gift of an installment sale note can create the immediate recognition of the taxable gain in the note. See: IRC section 453B and Revenue Ruling 79-371, 1979-2 C.B. 294. Of course, this is a problem only to the extent there is deferred taxable gain in the unpaid balance of the note.

Assignments and Marital Trusts. Clients with marital trusts that will be included in their taxable estates should consider how they can transfer trust interests in 2012, while the higher exemptions prevail. Among the alternatives:

- (1) If the trust provides for broad discretion in the Trustee to make distributions, the Trustee may be able to take into account the potential tax consequences (particularly those to the remaindermen) and make a distribution to the surviving spouse, who then makes a gift to his or her heirs.
- (2) The surviving spouse could gift his or her life interest to the remaindermen and the merger of the life interest with the remainder interest in the trust could cause the marital trust to expire. IRC section 2519 provides that the transfer of a QTIP life estate is treated as a gift of the entire trust interest, not just the surviving spouse's life interest. The principal problem with this approach is that it may force a direct distribution to the remaindermen and this may not be the best choice (e.g., an heir with a disability, or creditor claims).
- (3) In the alternative, the remaindermen could sell or gift their remainder interest to the surviving spouse and merger could result in the spouse owning the entire interest. The spouse would then be free to dispose of the trust interests in the most efficient manner.

Deathbed Gifting. Deathbed gifts can be a significant planning tool. However, in Revenue Ruling 96-56 (1996-2 C.B. 161) the IRS ruled that if the donor dies before annual exclusion gift checks clear his or her account, the gift is not removed from the taxable estate. In general, charitable death bed checks do not have to clear the decedent's accounts before death, while non-charitable gifts do have to clear the account to be completed. Bottom line? Make sure any checks clear the donor's account and that delivery of any documents (and appropriate recording, such as real estate deeds) occurs before the donor passes.

Retaining an Income Stream for Donors. When affluent clients are considering substantial gifts, a significant issue is how do they retain sufficient assets and income to support themselves for the remainder of their lives? This is normally the single most greatest impediment to making substantial gifts.

Run a cash flow projection of the client's current lifestyle costs and sources of cash flow (i.e., cash flow may differ from income). If there are asset sources (e.g., Exemption Trusts) in which the principal can be used for the donor client, consider annuitizing the principal value in your calculations to show the client how long their cash flow needs could be met, even if they give away a substantial part of their assets. Prioritize the source of funds by first depleting those assets which would otherwise be included in the donor's taxable estate (e.g., consider depleting the IRAs before the Exemption Trust created by a deceased spouse).

Distributions from Retirement Plans. Many clients have significant assets in retirement plans. The gifting of the plan assets will accelerate the income taxes, but there can be other alternatives:

- Distributions. Clients should evaluate the tax cost of taking distributions from retirement plans (particularly if they are in low income tax brackets), paying the related income tax and then gifting available funds to donees before they pass.
- ROTH Planning Opportunity. Clients with a limited life expectancy (particularly those with a taxable estate) should consider converting existing IRAs and retirement plans accounts to Roth IRAs in 2012, before income tax rates go up in 2013.

Trap: While stretch IRAs can provide significant long term benefits to heirs, clients who expect to have taxable estates need to make sure that they have accounted for the state and federal estate taxes which may be due on IRAs. Returning to a \$1.0 million exemption in 2013 could create unpleasant tax results for designated non-spousal beneficiaries. Assume a father's lifetime gifts eliminated his estate exemption, resulting in the transfer of the IRA to heirs, who incur an estate tax. Failure to provide a funding source for the estate tax could create a "tax-spiral" in which the withdrawal from the IRA to fund the estate tax creates an income tax liability. Each subsequent withdrawal from the IRA to pay the income tax creates another income tax liability. Unexpected taxes can also result if the IRA estate tax liability is apportioned to transfers that would otherwise not be taxable (e.g., charitable and marital transfers).

Determining Residency. A critical part of planning for clients facing a looming death is determining the state of their residency. Determine if moving the client's residency to another state creates more or less tax, probate and/or estate planning issues, particularly if they are expected to move to where their children live. For clients with multiple residences, advisors should determine which state offers the best results and then (if the client is able and willing to cooperate) actively build the facts around residency in that state.

Trap: The parents' health deteriorates and the children move the parents to the state of a care-giver child. That change could change the state of residency of the parents, resulting in unintended consequences to the existing estate plan, issues with regard to the legitimacy of some of the terms of their estate planning documents (e.g., failure to comply with state law governing Powers of Attorney) and unexpected state death taxes and income taxes.

Practical Checklist. A practical checklist to document residency can be found at the author's website: www.scrogginlaw.com.

Powers of Attorney. Given the potential impending incapacity of a client, perhaps one of the first documents that should be signed is a comprehensive durable general power of attorney and medical directive. The power of attorney may permit broad gifting (particularly annual exclusion gifting) including gift advancements of bequests under the client's dispositive documents. It may permit the change of beneficiaries of life insurance and retirement plans.

Beware: If the gifting powers of the holder of the Power of Attorney are too broad, the power might be considered a General Power of Appointment, pulling the assets into the power holder's estate.

Trap. There is a potential unintended consequence of giving a broad gifting right under a power of attorney: the person holding the power may be effectively forced to use it. Assume a chronically ill 93 year old widow names her family attorney as the holder of her power of attorney over her \$15M estate. Clearly, if permitted by the terms of the general power of attorney, the attorney should consider the use of the \$5.12 million gift exemption in 2012 to advance bequests. But in the exercise of the general power of attorney, should the attorney act more aggressively? For example, should the attorney make taxable gifts using the 2012 gift tax rate of 35%? What happens if the client passes in 2013 and the applicable estate tax rate is 55%? Will heirs charge that the attorney breached his responsibilities by not making larger gift advancements? What is the proper amount of the gift that eliminates this potential breach of duty?

Plan for Losses. A pivotal part of the planning for any terminally ill client starts with examining their most recent federal income tax returns, prior year transactions which are not yet reflected on an income tax return and the unrealized losses in the current assets of the client's estate. Because of the recent economic downturn, many clients have significant losses in their assets. If they die, the basis in assets could step-down to their fair market value, resulting in an elimination of the tax loss that could have come from the sale of the asset. Dealing with significant unrealized loss assets should be a part of the client's estate plan.

Estate Conflicts. In the midst of all of the other issues, the practitioner should analyze where potential contests and conflicts exist to the overall estate plan and attempt to minimize those sources of challenge. The closer the client is to death the more likely that issues of diminished capacity, undue influence, depression, mistakes and other issues will be raised by unhappy heirs.

Conclusion: Staring into a murky crystal ball, trying to discern the indeterminable mind of Congress and the impending passing of a client, we have to realize that even in chaos and uncertainty, tax opportunities exist. But the hardest part of this planning is not the uncertainty of the tax laws – it is the understandably low

priority given to tax planning by many families facing the tragedy of the looming death of a loved one.

Practical Checklist. A practical checklist on planning for the terminally ill can be found at the author's website: www.scrogginlaw.com .

John J. ("Jeff") Scroggin has practiced as a business, tax and estate planning attorney and as a CPA with Arthur Andersen in Atlanta. He is a member of the Board of Trustees of the University of Florida Levin College of Law and holds a BSBA in accounting, J.D., and LL.M (Tax) from the University of Florida. Jeff served as Founding Editor of the NAEPC Journal of Estate and Tax Planning for five years and was Co-Editor of Commerce Clearing House's Journal of Practical Estate Planning for two years. He is the author of over 240 published articles and columns. He has been named as a Georgia Super-Lawyer and Five Star Wealth Advisor for the last four years. Jeff is a nationally recognized speaker on estate, business and tax planning issues and has been quoted extensively in national media .