Warner Norcross & Judd LLP
ATTORNEYS AT LAW

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Trusts & Estates Newsletter

Estate Planning Focus

Estate Taxes: Gazing Into The Crystal Ball

by Todd W. Simpson

As estate planning attorneys, we like certainty. We craft language to avoid ambiguity and plan with clients to identify and eliminate unnecessary risk. The estate tax system, however, is in a state of flux. Unless Congress intervenes (as we expect they will), the federal estate tax is scheduled to disappear in 2010, only to return in 2011 with higher tax rates and lower exemptions than we currently enjoy. This uncertainty presents a challenge, but does not preclude effective tax planning.

WHAT'S CERTAIN

Nothing. Well, almost nothing. If you die in 2008, the effective federal estate tax exemption available to your estate is $2 million. If your estate (including certain large gifts made during life) is below this amount, no federal estate tax will be due.

The $2 million exemption is potentially available to each spouse of a married couple, allowing them to collectively pass $4 million free from federal estate tax, but proper planning is required to preserve this potential. Under current estate tax laws, the individual exemption is scheduled to increase to $3.5 million in 2009. Beyond 2009, the situation is less clear.

WHAT'S ALMOST CERTAIN

It is almost certain that the federal estate tax isn't going to be permanently repealed anytime soon. Several years ago, repeal appeared to be a realistic possibility. A change in control of Congress, hurricane Katrina, extended and expensive military campaigns in the Middle East and the general economic downturn have stalled any momentum toward repeal.

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Editor's Note
News You Can Use

Welcome to the new Estate Planning Focus newsletter from Warner Norcross & Judd. New? Well, not exactly. It has a different look, but the intent of the newsletter remains the same: To bring you information about trusts and estate planning that you can use to manage your wealth.

For example, in this edition we talk about paying a little in taxes now to save a lot later. In fact, in the example we show how a person with a $7 million estate is able to save nearly $400,000 in estate taxes. That's the type of practical information we hope to supply you with in coming editions.

Our attorneys also keep close tabs on what's happening legislatively in Lansing and Washington. Inside this edition you will find the latest on the Michigan Business Tax and how it affects trusts, Family Limited Partnerships and Family Limited Liability Companies.

Another story examines GRATs and IDITs. If you don't know what those are, now is the time to find out — especially in today's stagnant economic conditions.

We are adding a new feature to our lineup. It's called "I Was Wondering …" and is designed to be an interactive column with Warner's T&E attorneys answering questions from readers.

We hope you find this newsletter interesting and informative. And again, thank you for choosing Warner Norcross & Judd.

The Editors

These Planning Techniques take advantage of a Poor Economy

by Ann E. Liefer

There are some positives coming out of this stagnant economy. Current market conditions and low interest rates have created a window of opportunity to implement leveraged transfers that shift substantial amounts of growth and appreciation while paying little or no gift taxes.

There are two types of trusts that are particularly appropriate to use right now when transferring assets to your beneficiaries that are expected to appreciate significantly in the future. Grantor Retained Annuity Trusts (GRATs) and sales to Intentionally Defective Irrevocable Trusts (IDITS) essentially freeze the value and return of the transferred assets at today's prices and yields.

In a down economy such as this one, that's a big deal.

Why? Because the result is that the appreciation and increased yields in the future accrue to the benefit of your beneficiaries and allow you to avoid or reduce gift taxes now and estate taxation later on the assets that are transferred.

A GRAT is a trust created by a grantor that provides the grantor with an annuity for a period of years, and then passes the remainder to the beneficiaries named in the trust. Gift tax is payable on the present value of the remainder interest, which is the value of the property transferred to the trust less the value of the retained annuity. Because the present value depends on the interest rate, current lower interest rates increase the value of the annuity and therefore reduce the value of the remainder interest.

The grantor receives a stream of payments from the trust for a specific period for a term of years selected by the grantor. After that period ends, any remaining assets are left to the trust's beneficiaries, which then can be distributed immediately to the beneficiaries or remain in trust. The amount of remaining assets depends on the

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New Business Tax Has Planning Impact, Too

by Jay A. Kennedy

The new Michigan Business Tax has little impact on estate planning, right?

Wrong.

There is an ongoing concern that the MBT can be applied to trusts, Family Limited Partnerships and Family Limited Liability Companies, because there is no exclusion from the definition of "business activity" for investment activities. Likewise, under the new MBT there is no exclusion for casual sales, which are generally sales other than those in the ordinary course of a taxpayer's trade or business, and were exempt from the MBT's predecessor, the Single Business Tax.

AN IMPERFECT SOLUTION

In December, state lawmakers recognized that the MBT could be applied to estate planning techniques so they passed an amendment to rectify the situation — sort of.

Their first attempt at correction, Public Act 145, left too much to interpretation in regard to trusts, FLPs and FLLCs.

The act provides an exemption from "gross receipts" as follows: "For an individual, estate, partnership organized **exclusively** for estate or gift planning purposes, or trust organized exclusively for estate or gift planning purposes, amounts received other than those from transactions, activities and sources in the regular course of the taxpayer's trade or business, including the following …"

I emphasized the key word in the above paragraph. A significant concern for families with FLPs and FLLCs is that these entities are arguably never set up exclusively for estate or gift planning purposes. While these entities are often recommended as a means of transferring real estate or other assets to family members at a reduced estate and gift tax cost, they also promote centralized management, continuity and other business purposes, and are therefore not organized exclusively for estate or gift planning purposes. In fact, many experts believe that business purpose is necessary to support the minority and marketability discounts that produce the estate and gift tax savings.

A NEW PROPOSAL

So the Legislature is going back to the drawing board.

Under significant pressure from estate planners and others, the Michigan Senate has introduced new legislation intended to clarify the exemption for gross receipts received by trusts, FLPs and FLLCs. Senate Bill 1038 would basically remove "exclusively" from the statement "organized exclusively for estate or gift planning purposes."

Removing that single word would generally exempt gross receipts of entities in which one of the purposes of organization is estate or gift planning. The Senate passed the measure in February and it is awaiting action in the House.

A SIGNIFICANT CONCERN FOR FAMILIES WITH FLPS AND FLLCS IS THAT THESE ENTITIES ARE ARGUABLY NEVER SET UP *EXCLUSIVELY* FOR ESTATE OR GIFT PLANNING PURPOSES.

PLANNING CONSIDERATIONS

Families with trusts, FLPs and FLLCs should consider the following in determining the appropriate steps to minimize the impact of the MBT:

- Entities with less than $350,000 of gross receipts are generally exempt from the MBT. However, the MBT utilizes a "unitary" approach, which generally means that entities under common control will be treated as a single entity for purposes of determining qualification for exemption under the $350,000 rule.
- While SB 1038, if passed by the House, should offer some comfort to "traditional" trusts, FLPs and FLLCs established for estate planning purposes, the current law's language of "exclusively for estate or gift planning purposes" is troublesome.
- More active FLPs and FLLCs may not be exempted under SB 1038 if gross receipts of these entities are received in the "regular course of the taxpayer's trade or business." A significant factor in determining whether an entity is engaged in a trade or business is the level of the entity's trading and other activities.
- Some experts have advised entities with MBT exposure to move out of Michigan to avoid these problems. A decision to move out of Michigan should consider MBT "nexus" rules for determining non-Michigan status.

Contact your Warner Norcross & Judd advisor if you have questions regarding the impact of the Michigan Business Tax on your family's estate planning.

Paying Gift Tax Now Can Save Money Later

by Karen L. Kayes

Paying some taxes now can save you plenty in taxes later. The key is the type of tax you pay now that could reap long-term benefits.

A basic tenant of most estate planning is the avoidance of, or at least reduction in, payment of taxes to the IRS. One way to reduce an estate tax liability is to reduce the value of an estate through gifting. There are numerous ways to make gifts, even significant gifts, without paying tax. Why, then, would the payment of tax be part of a suggested gifting program?

HISTORY

First, let's take a look at the history involved here. The transfer of wealth through gratuitous transfers of property has been subject to federal tax by the IRS since 1924. It was introduced after Congress realized that Americans were avoiding the estate tax, introduced in 1916, by gifting wealth during life. The gift tax was repealed in 1926, but it was reinstated in 1932. At that time, a donor was allowed to gift $50,000 tax-free during life, and $5,000 per recipient annually. The gift tax rate was three-quarters of the estate tax rate until 1976, when Congress unified the estate and gift tax system.

In 2006, 7,663 returns reporting a taxable gift were filed with the IRS. The taxable gifts in that year totaled $7,360,892,307. Of that amount, $1,653,719,870 was paid to the IRS in gift tax.

That is certainly a significant amount of gift tax.

TAX-FREE GIFTING

Not all gifts are created equal, however. Especially in the eyes of the IRS. Any transfer that is for less than full and adequate consideration is taxable. But there are multiple deductions and exclusions:

- All transfers to a U.S. citizen spouse and transfers of the first $125,000 to a non-citizen spouse are free of tax.
- Direct payments to medical institutions or individuals who provide medical care to third parties are not taxed.
- Direct payment of an individual's tuition to a qualified educational organization avoids the gift tax.
- The first $12,000 of a gift per recipient (commonly referred to as the "annual exclusion") are free of gift tax.
- Use of the lifetime credit (currently $1 million) for gifts in excess of the annual exclusion.
- Charitable gifts.
- Gifts to qualifying political organizations.

CHANGING LAW

In 2008 and 2009, the gift tax rate is 41 percent for taxable gifts between $1 million and $1.25 million, 43 percent for taxable gifts between $1.25 million and $1.5 million and 45 percent for taxable gifts in excess of $1.5 million. But file away this bit of information: In 2010, under current law, the maximum gift tax rate is 35 percent.

This year is also the first year when the estate and gift tax exemptions are no longer the same. Although the gift tax exemption is $1 million, the exemption from estate tax is $2 million. However, use of the gift tax exemption during life still reduces an equal amount of estate tax exemption available at the time of death.

PAYING GIFT TAXES TO SAVE ESTATE TAXES

Clearly, the use of deductible or excluded gift transfers can significantly reduce an estate tax liability. An additional benefit to removing the value of assets from the gross estate using the tax-free methods above is the elimination of the taxable income from those assets during life, as well as removing the growth on the assets and the addition to value from the income from the value of the decedent's estate at the time of death.

The value of taxable gifts (those in excess of the deductible/excluded amounts other than those using the lifetime credit above) is included in the value of the

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If your estate is large enough that estate taxes are an issue and your strategy has been to wait for repeal, it's time to start formulating a new plan of attack. Opportunities are available to reduce or eliminate the estate tax burden. Give us a call and we would be happy to discuss them with you.

WHAT'S PROBABLE

Although current law provides for the elimination of federal estate tax for one year only in 2010, that magical estate-tax-free year is unlikely to materialize. It is widely expected that Congress will implement some permanent federal estate tax exemption before 2010.

Because 2008 is an election year, that legislation is more likely to come in 2009, but several proposals have already been suggested. Most prognosticators predict a permanent exemption somewhere between $3.5 million (the amount already scheduled for 2009) and $5 million per person. Congress will also need to determine the rate(s) at which amounts over the exemption will be taxed — currently a flat 45 percent, but the highest marginal rate was 55 percent or higher as recently as 2001. For very large estates, the rate of taxation is even more important than the exemption amount.

Given that the anticipated changes in the federal estate tax system are likely to come during the next president's administration, it is worth noting the candidates' stated positions. Senator McCain has publicly supported a $5 million per person exemption (indexed for inflation) with a 15 percent tax rate on assets above the exemption. Senators Obama and Clinton have each publicly supported a $3.5 million per person exemption with a 45 percent tax rate on assets above the exemption — essentially making the current 2009 rules permanent.

"If your estate is large enough that estate taxes are an issue and your strategy has been to wait for repeal, it's time to start formulating a new plan of attack."

WHAT'S POSSIBLE

The possibilities are limited only by Congress's imagination and ability to agree upon a solution. Fundamental changes are unlikely, but two specific issues are worth noting.

First, Congress appears to be seriously considering making the federal estate tax exemption "portable" between spouses. That is, if the first spouse dies, but fails to make full use of his or her federal estate tax exemption, the unused exemption could later be used by the surviving spouse. This would be particularly beneficial in instances where the spouse who dies first has relatively few assets or has not adequately planned to preserve his or her exemption (for example, if most assets were held jointly between the spouses — generally a bad idea for estate tax planning). The "portability" of the federal estate tax exemption is not a complete substitute for proper planning and asset allocation between spouses, but would relieve some of the tax burden when this has not been (or cannot be) accomplished.

A second, and less welcome, possibility is the reemergence of a state estate or inheritance tax system. The discussion above relates only to the federal estate tax, because Michigan has had no estate or inheritance tax since 2004. Michigan's estate tax laws are still on the books, but the tax is defined in terms of a federal estate tax credit that was phased out between 2001 and 2004. We expect Congress to address federal estate taxes before 2010, but if it doesn't act, this federal credit will reappear in 2011 — and with it will come the return of the Michigan estate tax.

If Congress does act, that doesn't foreclose the possibility of a Michigan estate or inheritance tax. A number of states that, like Michigan, had previously defined their state estate tax in terms of this federal credit have enacted legislation since 2004 to create a state inheritance tax or estate tax regime that is independent of the federal credit. Given the state's financial condition, it is certainly possible that Michigan may follow the lead of those other states to capture some of this lost revenue.

WHAT'S NEXT FOR YOU

Estate taxes are complicated and planning is easy to delay or ignore. The tax dollars potentially at stake, however, suggest that those desiring to pass wealth to their family rather than to their government must plan wisely. We would welcome the opportunity to discuss your circumstances and ways in which to minimize your estate tax liability. Please give us a call if we can be of assistance.

I was Wondering

Q:
I already have a will. Is that good enough, or do I need a living trust, too?

A:
The primary advantage to making a living trust is that property in or payable to the trust doesn't have to detour through the probate court before it reaches the people you want to inherit it. In a nutshell, probate is the court-supervised process of paying your debts and distributing your property to the people who inherit it.

A will, while a very important estate planning tool itself, does not avoid probate. In fact, only assets that are subject to probate, generally those in an individual's name alone at death, are subject to the terms of a will. The average probate can take months before the inheritors get anything. And by that time, there is usually less for them to get because attorney fees and court costs can diminish the estate. If you don't have a will, any property that isn't transferred by your living trust or other probate-avoidance device (such as joint tenancy) will go to your closest relatives in an order determined by state law. These laws may not distribute property in the way you would have chosen. Having both a will and a living trust eases the transition for heirs.

Q:
My dad recently died and left an estate worth $4 million. Most of this he left to his wife, and some to his three daughters. Does the wife's share apply first to the $2 million estate tax exclusion, leaving the daughters to pay the inheritance tax?

A:
Everything inherited by your dad's widow (if she is a U.S. citizen) is exempt from federal estate tax. If the daughters didn't inherit more than the estate tax exclusion ($2 million for deaths in 2006 through 2008), the estate won't owe any estate tax. If tax is owed, check your dad's will to see whether he specified what property should be used to pay it.

Your dad's executor must still file an estate tax return within nine months of death, however, because the total value of the estate exceeds $2 million. These returns are complicated, to say the least; the executor of your dad's estate should hire an experienced lawyer to handle it.

'I Was Wondering' gives readers an opportunity to ask questions of our T&E attorneys. Not all questions will be answered publicly. To submit a question, please send it by e-mail to Tim Gortsema at tgortsema@wnj.com

Paying Gift Tax continued

gross estate for estate tax purposes. However, the value is calculated as of the date of the gift. Therefore, all post-gift appreciation is excluded from the estate value.

The gift tax is levied on the value of the asset gifted during life. However, the estate tax is levied on all assets included in the decedent's estate, including the amount necessary to pay the estate tax. The funds used to pay the gift tax are not included in the decedent's taxable estate, unless the gift was made within three years of death. That means the payment of gift tax will actually decrease estate taxes if the donor survives for three years after having made the gift.

Not all gifts are created **equal**. Especially in the eyes of the IRS.

WORTH THE WORK?

Let's assume, for example, a single individual with a $7 million estate dies in 2008. The estate would pay $2.25 million in estate tax. If that individual gifted $3 million of assets during life, he would have paid $884,200 of gift tax. If he lived more than three years after paying the tax, but assuming 2008 estate tax rates, the $884,200 of tax would be excluded from his estate. Although the $3 million of gifted assets is included in the taxable estate, the estate tax actually would be $1,852,110 — a savings of almost $400,000.

Although it may seem absurd and certainly painful to pay taxes to the IRS, there may be clear economic advantages to doing so.

T&E Group Welcomes Eberhard

David C.C. Eberhard has joined the Trusts and Estates Group and will practice from the firm's Sterling Heights office.

David is a former partner with O'Reilly Rancilio P.C. in Sterling Heights and brings with him 13 years of legal experience.

In addition to T&E, David also practices in the areas of corporate law with an emphasis on business acquisitions, commercial real estate and development and education law.

Active professionally and in the community, David serves as a council member of the Business Law Section of the State Bar of Michigan and is a member of the American Bar Association, Macomb County Bar Association and Macomb County Probate Bar Association. He is also a member of the Michigan Council of School Attorneys and the Lutheran Attorneys in Witness Bar Association. He serves on the board of Historic Trinity Lutheran Church and is the acting secretary of the Lutheran Heritage Foundation.

David received his bachelor's degree from the University of Michigan and doctor of jurisprudence from the University of Detroit Mercy School of Law. He can be reached by calling (248) 784.5187.

Planning Techniques continued

performance of the assets that fund the trust. Accordingly, the best assets to transfer to a GRAT are those you reasonably expect to appreciate at a higher rate than the current interest rates. These assets may include stocks, real estate or interests in a closely held business.

Sales to IDITs provide benefits similar to those of a GRAT. After the grantor creates an IDIT, he or she sells assets to the trust in exchange for an interest-bearing installment note from the trust.

In this scenario, the grantor does not recognize a gain or loss on the sale and is not required to pay tax on the interest payments received on the note. After the sale, any appreciation on the assets sold to the IDIT in excess of the amount of interest payments on the note will remain in the trust, ultimately to be distributed to the trust beneficiaries without incurring gift taxes. Accordingly, like a GRAT, a sale to an IDIT should use assets that are likely to appreciate significantly during the term of the note.

The current state of the market and interest rates has created exceptional planning opportunities for those with assets that will appreciate significantly in the future and who are willing to transfer those assets now. In those cases, GRATs and sales to IDITs are two planning options that should not be overlooked. Contact your Warner Norcross & Judd attorney for more information or for help in taking advantage of these timely options.

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