The Estate Planner

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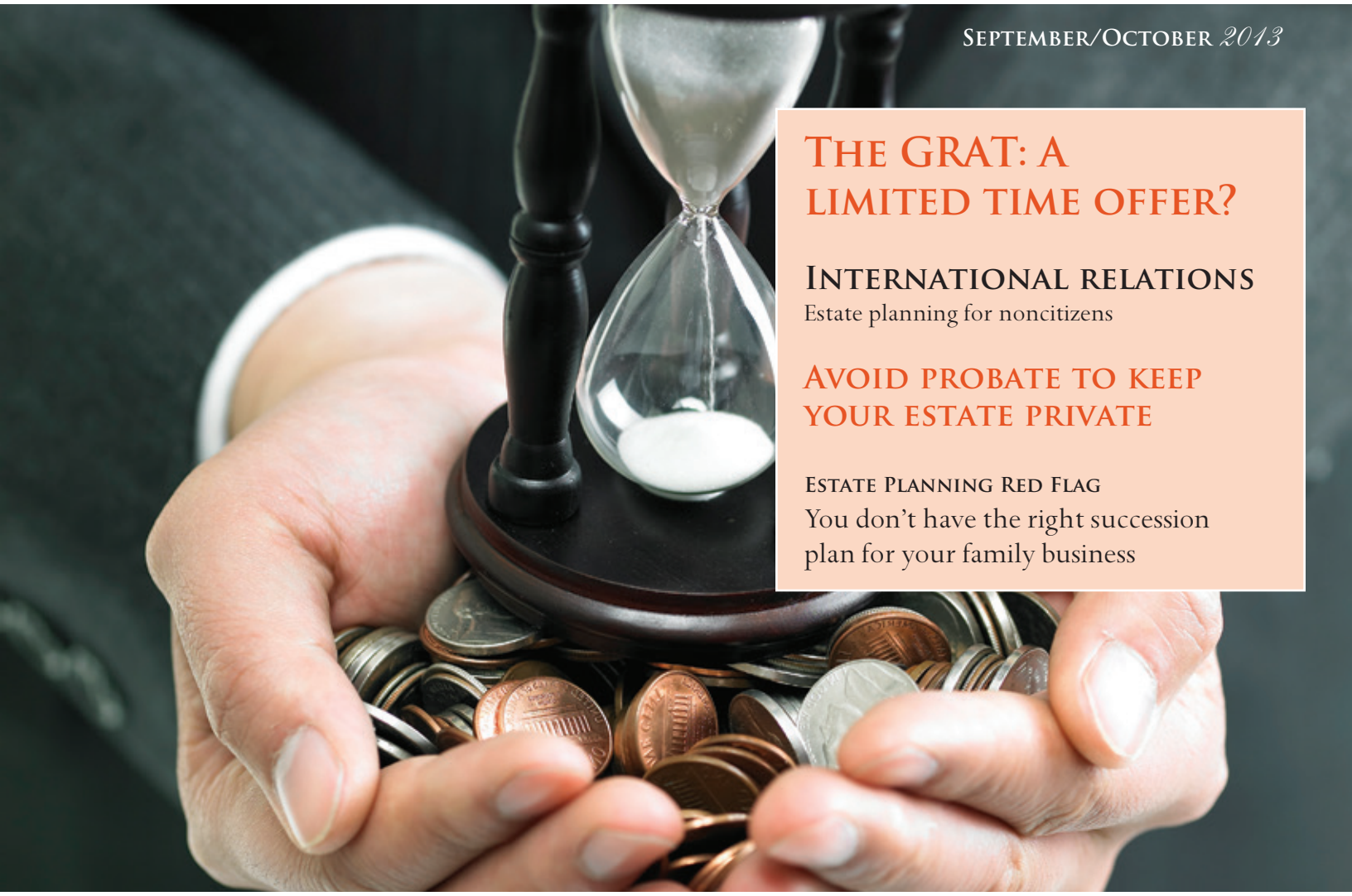

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The GRAT: A limited time offer?

The grantor retained annuity trust (GRAT) has long been a popular tool for transferring wealth while minimizing or even eliminating gift and estate taxes. GRATs are particularly effective when interest rates are low, as they are now.

In recent years, however, some lawmakers have introduced legislation that would water down the benefits of GRATs in an effort to boost tax revenues. So far, these efforts have failed, but interest in such legislation remains high.

If you're considering one or more GRATs as part of your estate planning arsenal, now may be the time to pull the trigger, before Congress reduces their firepower.

How GRATs work

A GRAT is an irrevocable trust designed to hold appreciating assets, such as closely held business interests, stock or real estate. You make a one-time contribution of assets to the trust in exchange for an annuity during the trust's term. Typically, the annuity is a fixed dollar amount or a fixed percentage of your initial contribution's value.

> *Because a GRAT is a "grantor trust," you, as grantor, remain responsible for taxes on any income generated by the trust assets.*

At the end of the trust's term, the remaining assets pass to your children or other beneficiaries. Because a GRAT is a "grantor trust," you, as grantor, remain responsible for taxes on any income generated by the trust assets. This is an advantage, because it allows the trust assets to grow and compound tax-free without being eroded by income taxes.

Here's the key to a GRAT's tax-saving power: When you contribute assets to the trust, their value for gift tax purposes is equal to the present value of your beneficiaries' expected remainder interest. That value is determined by using the Section 7520 rate, which is the *presumed* rate of return earned by the trust's assets during the GRAT's term. Because the Sec. 7520 rate is conservative — recently, it's been in the 1% to 1.4% range — it tends to produce relatively low gift tax values.

If you set the annuity amount high enough, you can even "zero out" a GRAT — that is, produce a remainder interest of zero, resulting in zero gift tax liability. If the trust assets outperform

the Sec. 7520 rate — which isn't hard to do in a low-interest-rate environment — the excess earnings pass to the beneficiaries tax-free. (See "A GRAT example" at right.)

Watch out for mortality risk

Long-term GRATs — those with trust terms of 10 years or more — offer certain advantages. By spreading the annuity payments over a longer period, you can defer income taxes. And a longer investment horizon increases the chances that the trust will outperform the Sec. 7520 rate.

But there's also a downside to long-term GRATs: To enjoy the tax benefits, you must survive the trust term. If you don't, all of the trust assets will be brought back into your estate and subject to estate taxes. To minimize this "mortality risk," it may be advisable to choose a short term — say two to four years — particularly if you're older or concerned about your health.

Legislative proposals

During the last few years, several lawmakers have proposed tax changes that would limit the benefits of GRATs. Typically, these proposals involve establishing a 10-year minimum term and a minimum remainder value, such as 10% of the value of the initial contribution — in other words, no more short-term GRATs and no more zeroed-out GRATs.

President Obama's 2014 budget proposal calls for a minimum 10-year term and would require a GRAT's remainder interest to have a value "greater than zero" at the time the interest is created.

Act now

If you're thinking about using GRATs to transfer wealth to your children or other beneficiaries, consider acting sooner rather than later, particularly if you wish to take advantage of short-term or zeroed-out GRATs. If a law establishing a minimum term or minimum remainder value is enacted, it will likely be too late.

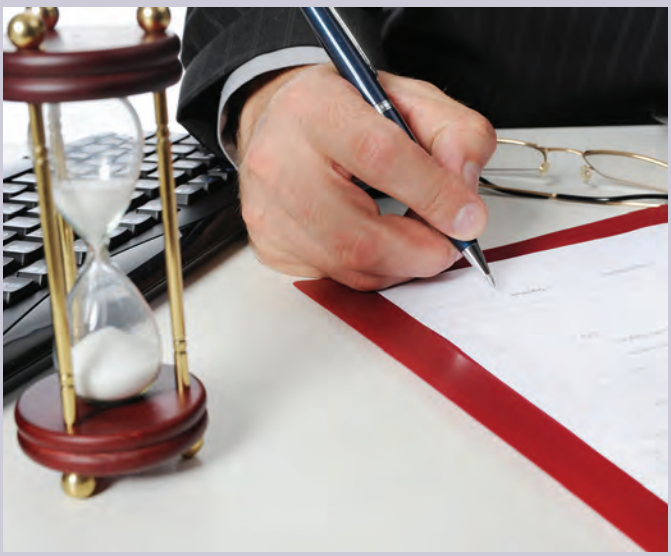
But keep in mind that, even if lawmakers reduce the benefits of the GRAT, it'll continue to be an effective estate planning tool under the right circumstances. ✤

A GRAT example

Paul has already used up his $5.25 million gift and estate tax exemption. He'd like to make a substantial gift to his son, Joe, but doesn't want to trigger gift taxes. Paul transfers $5 million in stocks and other investments to a three-year grantor retained annuity trust (GRAT) for Joe's benefit at a time when the Section 7520 rate is 1.4%.

He sets the annuity payment at $1,713,561, which, according to IRS tables, is the amount that will zero out the GRAT. In other words, if the GRAT assets earn a 1.4% return, the annuity payments will deplete the trust, leaving Joe with nothing.

If the GRAT outperforms the Sec. 7520 rate, however, Paul will succeed in transferring a substantial amount of wealth to Joe free of gift taxes. For example, if the trust earns a 6% return, Joe will receive approximately $500,000 gift-tax-free.



International relations

Estate planning for noncitizens

For U.S. citizens, the federal gift and estate tax rules are relatively straightforward: Citizens are subject to U.S. transfer taxes on their worldwide assets. They're also entitled to a generous lifetime gift and estate tax exemption, an annual gift tax exclusion, and a marital deduction that allows spouses to transfer unlimited amounts of property to each other tax-free. For noncitizens, however, things get a bit complicated.

Where's your domicile?

The question of "domicile" is critical to international estate planning. According to IRS regulations, you acquire a domicile in a place "by living there, for even a brief period of time, with no definite present intention of later removing therefrom." Of course, the IRS can't read your mind, so it determines your domicile by examining a variety of factors, including the amount of time you spend in the United States, visa status, location of business interests and residences, the domiciles of friends and family members, and community ties.

If you're a noncitizen who's deemed to be a U.S. domiciliary, then you're subject to U.S. gift and estate taxes on your worldwide assets, much like a U.S. citizen. You're also eligible for the $5.25 million exemption, the $14,000 annual gift tax exclusion and gift-splitting with your spouse (so long as your spouse is a U.S. citizen or domiciliary).

> *Identifying taxable, U.S.-situated property is more complicated than you might think.*

If you're *not* a U.S. citizen or domiciliary — in other words, if you're a "nonresident alien" — then you're subject to U.S. gift and estate taxes only on property that's "situated" in the U.S. But your exemption drops to $60,000. This represents a major tax trap for nonresident aliens. If a significant amount of your wealth is situated in the United States, your heirs may be facing a substantial estate tax bill.

Where's your property?

Identifying taxable, U.S.-situated property is more complicated than you might think. It includes U.S. real estate as well as tangible personal property — such as art, jewelry, cars, boats, antiques and collectibles — physically located in the United States. But for intangible property — such as stock, LLC units, partnership interests and debt obligations — there are different rules for gift and estate taxes.

Generally, a nonresident alien's transfers of intangible property are exempt from U.S. gift tax, even if the property is located in the United States. For *estate* tax purposes, however, certain transfers of intangibles are

taxable, including stock in a U.S. corporation and, in some cases, partnership interests, LLC units and debt obligations (including certain bank deposits).

A full discussion of the rules regarding the tax situs of property is beyond the scope of this article, but if you're a nonresident alien with U.S. property interests, it's important to review the rules with your estate planning advisor and consider strategies for reducing your tax exposure. For example, it may be possible to avoid U.S. estate taxes by holding U.S.-situated assets through a properly structured and operated foreign corporation. In some cases, tax treaties between the United States and other countries may provide additional protections.

What about the marital deduction?

For U.S. citizens, the unlimited marital deduction is an important estate planning tool. But can noncitizens also take advantage of the deduction? The answer, as with so many tax questions, is "it depends."

The unlimited marital deduction is available if the *recipient* of a transfer is a U.S. citizen, even if the transferor is a noncitizen. If the recipient is a noncitizen, however, the deduction isn't available, so additional planning is required. Options include:

- Using the transferor's lifetime exemption to make tax-free transfers to the noncitizen spouse,
- Making annual exclusion gifts (currently, the annual exclusion for gifts to a noncitizen spouse is $143,000), and
- Transferring assets to a qualified domestic trust (QDOT). A QDOT must meet a variety of requirements designed to ensure that the assets stay in the United States and are eventually subject to estate taxes.

Of course, the most effective option, at least from an estate planning perspective, is for the noncitizen spouse to become a U.S. citizen.

Assess your situation

If you or your spouse is a noncitizen, be sure to consult your estate planning advisor to discuss the potential impact on your estate plan and strategies you can use to minimize adverse tax consequences.

Avoid probate to keep your estate private

Few estate planning subjects are as misunderstood as probate. But circumventing the probate process is usually a good idea. Why? Because the process is a public one — meaning anyone can learn what assets you owned during your lifetime and how they'll be distributed after your death. This can lead to family disputes over asset distribution.

You can keep much (or even all) of your estate out of the probate process (and the public eye) by using the right estate planning techniques.

Probate 101

Probate is a legal procedure in which a court establishes the validity of your will, determines the value of your estate, resolves creditors' claims, provides for the payment of taxes and other debts and transfers assets to your heirs.

Is probate ever desirable? Sometimes. Under certain circumstances, you might feel more comfortable having a court resolve issues involving your heirs

people avoid probate by holding title with a spouse or child as "joint tenants with rights of survivorship" or as "tenants by the entirety." But this has three significant drawbacks: 1) Once you retitle property, you can't change your mind, 2) holding title jointly gives the joint owner some control over the asset and exposes it to his or her creditors, and 3) there may be undesirable tax consequences.

and creditors. Another possible advantage is that probate places strict time limits on creditor claims and settles claims quickly.

Avoiding (or Minimizing) Probate

There are several tools you can use to avoid (or minimize) probate. (You'll still need a will — and probate — to deal with guardianship of minor children, disposition of personal property and certain other matters.)

The simplest ways to avoid probate involve designating beneficiaries or titling assets in a manner that allows them to be transferred directly to your beneficiaries outside your will. So, for example, be sure that you have appropriate, valid beneficiary designations for assets such as life insurance policies, annuities and retirement plans.

For assets such as bank and brokerage accounts, look into the availability of "pay on death" (POD) or "transfer on death" (TOD) designations, which allow these assets to avoid probate and pass directly to your designated beneficiaries. However, keep in mind that, while the POD or TOD designation is permitted in most states, not all financial institutions and firms make this option available.

For homes or other real estate — as well as bank and brokerage accounts and other assets — some

Approximately 20 states permit TOD deeds, which allow you to designate a beneficiary who'll succeed to ownership of real estate after you die. TOD deeds allow you to avoid probate without making an irrevocable gift or exposing the property to your beneficiary's creditors during your lifetime.

The simplest ways to avoid probate involve designating beneficiaries or titling assets in a manner that allows them to be transferred directly to your beneficiaries outside your will.

Consider a Living Trust for Larger Estates

Bear in mind that the right strategies depend on the size and complexity of your estate. For larger, more complicated estates, a living trust (also commonly called a "revocable" trust) generally is the most effective tool for avoiding probate. A living trust involves some setup costs, but it allows you to manage the disposition of all of your wealth in one document while retaining control and reserving the right to modify your plan.

To avoid probate, it's critical to transfer title to all of your assets, now and in the future, to the trust. Assets outside the trust at your death will be subject to probate — unless you've otherwise titled them in such a way as to avoid it (or, in the case of life insurance, annuities and retirement plans, you've properly designated beneficiaries).

Probate Avoidance Only One Goal

Keep in mind that avoiding probate is just part of estate planning. Your estate planning advisor can help you develop a strategy that minimizes probate while reducing taxes and achieving your other goals. ✤

Estate Planning Red Flag

You don't have the right succession plan for your family business

If you own a family business, planning for its transition to your children is critical. And the earlier you begin the process, the better. Consider Dave: At age 60, he owns a successful business that he runs with his son, Max. A recent appraisal valued the business at $10 million, and that value is growing at a rate of about 5% per year. Dave's estate plan leaves the business to his wife, Jennifer (also age 60) and then to Max after Jennifer's death. Both Dave and Jennifer are U.S. citizens.

Unfortunately, this plan will likely lead to an enormous estate tax bill down the road. Why? Let's suppose that Dave dies in 10 years, leaving the business to Jennifer (generally tax-free, by virtue of the marital deduction), and that Jennifer dies five years later, leaving the business to Max. By this time, the company's value has grown to $20 million.

Assume for purposes of this example that the federal estate tax exemption and marginal tax rate are the same as they are now ($5.25 million and 40%, respectively), and that Dave and Jennifer haven't used any of their exemption amounts. The transfer of the business to Max will generate a $5.9 million estate tax liability. Even if "portability" allows Jennifer's estate to take advantage of Dave's exemption, the tax bill will be at least $3.8 million.

With better planning, Dave can minimize or even eliminate this tax liability. Suppose, for example, that Dave transfers 99% of the business to Max in the form of nonvoting shares. Assuming that those shares are entitled to a 40% valuation discount for lack of control, they're worth $5.94 million, generating a gift tax liability of $276,000. And if Dave and Jennifer split gifts, so that they each give Max $2.97 million, there will be no gift tax currently due. All future appreciation in the value of the business (other than the 1% interest retained by Dave) avoids gift and estate tax.

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The DOMA Minefield in Probate
By Kimberly Klatka

In *United States v. Windsor*, 2013 U.S. LEXIS 4921, the United States Supreme Court affirmed the judgment for the United States Court of Appeals for the Second Circuit holding the Defense of Marriage Act ("DOMA") unconstitutional. Justice Kennedy delivered the opinion of the Supreme Court, to which Justices Ginsburg, Breyer, Sotomayor, and Kagan concurred. Justices Roberts, Scalia, and Alito each wrote dissenting opinions, to which Justice Thomas joined in parts.

When Thea Spyer died, she left her entire estate to her spouse, Edith Windsor. Their marriage was recognized by the State of New York, but Windsor was barred from claiming federal estate tax marital deduction with respect to the value of the property she received as Spyer's surviving spouse by DOMA, which defined "marriage" and "spouse" as excluding same-sex partners. Windsor paid $363,053 in estate taxes and sought a refund, which the IRS denied. Windsor then filed this refund suit, contending that DOMA violates the principles of equal protection incorporated in the Fifth Amendment.

The United States District Court for the Southern District of New York ruled that DOMA is unconstitutional, and ordered the United States Treasury to refund the tax with interest, and the Second Circuit affirmed on appeal. Interestingly, while the tax refund suit was pending, the Attorney General refused to defend the constitutionality of DOMA, and stated that the Executive Branch had come to its own conclusion that classifications based on sexual orientation should be subject to a heightened standard of scrutiny, and DOMA was therefore unconstitutional. A Bipartisan Legal Advisory Group (BLAG) from the United States House of Representatives voted to intervene to defend, and petitioned the Supreme Court for certiorari after the Second Circuit's decision.

In its decision, the Supreme Court first established that it does have Article III Jurisdiction to consider the merits of the case because, even though the Executive Branch had refused to defend the constitutionality of DOMA, the U.S. Government continued to deny refunds to Windsor. Further, BLAG's sharp adversarial presentation of the issues ensured a real, earnest, and vital controversy. Finally, the Supreme Court desired to establish "precedential guidance" for lower courts. *Windsor* at *24.

The Supreme Court held that DOMA is unconstitutional, focusing on two major arguments. First, it stressed that the states possess full power over the subject of marriage and divorce and the U.S. Constitution delegates no authority to the Government of the United States on this matter. Second, the Supreme Court held that DOMA is unconstitutional as a deprivation of equal liberty under the Fifth Amendment. The Supreme Court emphasized that "DOMA's principal effect is to identify a subset of state-sanctioned marriages and make them unequal. Its principal purpose is to impose inequality." *Windsor* at *43. It went on to cite specific examples of how DOMA burdens the lives of same-sex spouses.

Justice Scalia dissented because in his view, given the Executive Branch's refusal to defend the constitutionality of DOMA, the Supreme Court lacked Article III Jurisdiction and the case should have ended upon the District Court's order of a refund. Scalia vehemently disagreed with the Supreme Court's holding that DOMA is unconstitutional. Scalia denied that the supporters of DOMA acted with malice and a "bare desire to harm" couples of same-sex marriage, but rather enacted DOMA to avoid choice-of-law issues by specifying which marriages would be federally recognized. For example, without DOMA the issue arises of whether a couple lawfully married in New York would be able to file a joint federal tax return if they moved to Alabama or another state that currently does not recognize same-sex marriage.

Chief Justice Roberts agreed with Justice Scalia's argument that the Supreme Court lacked jurisdiction to hear the case. He also agreed with Scalia that DOMA is constitutional, and that Congress' decision to create a definition of marriage was justified by "uniformity and stability." Roberts pointed out that this case does nothing to resolve future challenges to state marriage definitions affecting same-sex couples.

Justice Alito, joined partly by Justice Thomas, argued that the United States lacked standing, but that BLAG did have standing. He also opined that the Constitution does not guarantee the right to enter into same-sex marriage, and that substantive due process only protects "those fundamental rights and liberties which are … deeply rooted in this Nation's history and tradition." *Windsor* at *104. In regards to the equal protection argument, Alito took the position that it was a matter for the legislature, not the Supreme Court, to resolve the debate over the two competing views of marriage. Alito believed that DOMA did not encroach upon the states' governance of marriage because it defined a class of persons to whom *federal law* extends benefits or imposes burdens.

With DOMA's definition of marriage now gone, same-sex couples can now benefit from the unlimited marital deduction for transfers of wealth between spouses during life and at death, and attorneys and clients must revisit the clients' estate plans to make certain the clients' affairs are restructured to take into account the various changes resulting from the recognition of same-sex marriage and the unconstitutionality of DOMA. Should you have any questions about DOMA and how it may impact your estate planning, feel free to contact your Weston Hurd attorney.