IRS Declares Sales of Property From One Spouse's Grantor Trust to the Other Spouse's Grantor Trust to be Tax Free Transactions

In a recent Private Letter Ruling the IRS declared that sales of property between spouses and the spouses' grantor trusts do not trigger income taxation. This ruling validates a planning technique using special trusts called Spousal Lifetime Access Trusts (SLATS) and transactions between the spouses and these trusts. This type of planning is used to minimize or avoid estate tax and to protect assets from creditors and divorce. Please see PLR 201927003, Rev Rul 85-13, 1985-1 CB 184, and Code Sec. 1041(a).

Contact Carl Holborn at 414-276-5000 or Carl.Holborn@wilaw.com if you would like to learn how these trusts can be used to eliminate the estate tax and protect assets.

Electronic Data and On-Line Information Is of Increasing Importance During Estate Planning

It has been estimated that over 90% of all business information today is created electronically. Use of social networking websites, such as Facebook, on-line photography accounts like Flicker, e-mail passwords and word processing files, is increasingly more common.

Various media commentators have addressed the need for individuals to consider their electronic data and on-line postings in conjunction with their estate planning. For example, the New York Times Magazine published a substantial article relating to this topic in its January 9, 2011 edition. Yet, because the rise of digital information is a relatively new phenomenon, many people have not yet fully considered or developed their plans for handling their electronic data and on-line profiles after death, or taken steps to minimize potential disputes about such items that could arise after death.

If you would like more information on this topic, please contact Carl Holborn at O'Neil, Cannon, Hollman, DeJong & Laing S.C. at 414-291-4704 or carl.holborn@www.wilaw.com.

Congress Debates Limiting Estate Planning Technique: Now Is a Good Time to Consider a GRAT

The grantor retained annuity trust (GRAT) has been a staple vehicle for estate planning since it was first introduced twenty years ago by the Revenue Reconciliation Act of 1990. A GRAT can effectively transfer property from a grantor to a beneficiary, while greatly reducing the amount of tax the grantor would otherwise owe on the gift, if the gift was transferred without a GRAT.

A GRAT is created by transferring property to a trust for a fixed number of years. During the life of the trust, the grantor is paid an annual annuity from that trust. Upon the expiration of the trust, any remaining property in that trust passes to the beneficiary. Tax savings are realized by placing property expected to greatly increase in value into the trust. Tax is then assessed by adding the value of the initial property plus a statutorily fixed interest rate based on the month the trust was created as found in Code Sec. 7520. The current fixed interest rate for August 2010 is 2.6%, according to Rev. Rul. 2010-19. Therefore, as long as the annuity payments over the fixed period of the trust equal the initial property value plus the fixed interest rate, there would be no gift tax assessed on any remaining property left in the trust upon expiration, which would be automatically transferred to the beneficiary.

In other words, if a GRAT is created this month with any type of property expected to appreciate more than 2.6% over the life of the trust, any profits greater than 2.6% would be considered a tax free gift by the IRS to the beneficiary without requiring the donor to utilize a portion of the standard $1,000,000 lifetime gift tax exemption. Currently, the minimum term of a GRAT is two years and there are no restrictions on the structure of annuity payments, effectively allowing a donor to have little to no tax burden if properly created.

Recently Congress has been considering limiting the effectiveness of GRATs. President Obama’s 2010 budget proposal and 2011 revenue suggestions sought to change the minimum term of a GRAT from two to ten years. Additionally, the House attempted to attach a similar curtailment of GRAT to a small business jobs bill and a supplemental spending bill. The Senate’s version of the small business jobs bill did not contain the GRATs provision, and ultimately the House was unsuccessful is attaching the provision to the supplemental spending bill. However, the Senate currently has a GRAT curtailment provision in a proposed COBRA extension act, S. 3548, to provide funding for the bill, an increasingly common trend for proposed anti-GRAT legislation.

The current Senate bill proposes to (1) raise the minimum GRAT term to ten years, (2) require the remaining interest, as calculated at the time of GRAT creation, to be greater than zero, and (3) prohibit the annuity payments from decreasing in value from the first year until after the initial ten years of the trust. These proposed changes have the potential to significantly alter GRATs as we know it. By raising the minimum term to ten years, a grantor increases the chances that he or she may pass away prior to the GRAT expiring. A GRAT that is ongoing at the time of the grantors death reverts back to the estate of the grantor, along with any appreciation, and does not transfer to the beneficiary. In this scenario, not only does the beneficiary get nothing, but the property is now taxable to the grantor's estate. Furthermore, by disallowing decreased payments, the proposed bill shuts the door on scheduling high initial payments to reduce the amount of the trust that reverts back to the estate. Lastly, the bill creates great uncertainty about exactly how much "greater than zero" the gift must be, meaning that there will likely be disagreements between the IRS and GRAT creators until initial revenue rulings are proposed.

Currently, GRATs are functioning without any of the proposed limitations. However, as the above government actions indicate, that is likely to soon change. Therefore, if you have property that is likely to appreciate more than 2.6% over at least the next two years, and you wish to avoid using part or all of your lifetime $1,000,000 gift tax exemption to transfer that property, now is the time to create and fund a GRAT. Any GRAT created and funded prior to the enactment of any legislation, similar to what is described above, will be grandfathered in to the old GRAT tax laws and you will still receive the significant tax benefits that GRATs currently provide. However, if you wait too long, it is likely that you will miss out on fully capitalizing on one of the best intergenerational wealth preservation techniques currently available.

Unmarried Couples Taking Advantage of the Homebuyer Tax Credit Should Understand Their Rights

The Homebuyer Tax Credit is scheduled to expire soon. To take advantage of the tax credit, homebuyers must enter into a binding contract to purchase a home before May 1, 2010, and they must close on the home before July 1, 2010.

Not surprisingly, many unmarried couples have sought to take advantage of the tax credit by purchasing a home together. Those unmarried couples doing so should consider the following issues:

- Will each person pay an equal amount for the down payment and closing costs?
- If not, will each person own an equal share of the home?
- Will each person be responsible for an equal share of the monthly mortgage payment?
- What happens if one person is unable to make a timely monthly mortgage payment? If the other person makes up the difference, is this treated as a loan, a gift, or does it affect the ownership percentage in the home?
- Who gets to decide on necessary repairs/maintenance for the house, and who must pay for them?

Similarly, who gets to decide on unnecessary repairs/maintenance for the house, and who must pay for them?

- Will anyone else be permitted to live in the house? For example, a friend, sibling, or parent in need of a place to stay? If so, will they pay rent?
- Will either person be compensated for labor expended on or around the home (e.g. lawn work, painting, cooking, laundry, etc.)?
- What happens if one person can no longer afford the home and wants to sell? If one person dies?

While the blissful couple may believe that a spoken agreement will suffice, they should be mindful of the potential pitfalls of such an arrangement, especially if the relationship falters. For this reason, it can be very beneficial to obtain a Home Purchase and Co-Tenancy Agreement to ensure each party is aware of their rights and responsibilities, both during and after the relationship.

Estate Planning for Married Individuals with Children from a Prior Marriage

Effectively drafting estate plans for married individuals with children from a prior marriage can be a challenge. Failure to properly plan can cause divisive family disputes. There are many variables to be considered and competing interests that need to be balanced when preparing an appropriate plan. A common concern is that the spouses want to take care of each other during their lives, but also want their children from a prior marriage to receive some inheritance. There are generally two techniques to address this concern: 1) an immediate division of assets between the surviving spouse and the children from the prior marriage, or 2) the creation of a trust upon death where the surviving spouse has an interest in the trust for his or her lifetime, and the children receive the remainder upon the death of the surviving spouse. Often a combination of these two techniques is employed.

The advantage to an immediate division of assets is simplicity and certainty. The client identifies which assets are to be distributed to the surviving spouse and which assets are to be distributed to their children. The assets may be divided equally or on some percentage basis among the children and the surviving spouse. Most often, certain assets may be distributed to the spouse and certain assets may be distributed to the children. For example, the surviving spouse may receive the residence and a 401(k) retirement account, and the children from the prior marriage may receive the proceeds of a life insurance policy and an investment account. A drawback to this technique is that there may not be enough assets to provide a lifetime benefit for the surviving spouse. Also, it is important to monitor the basket of assets that is to go to the spouse and children as the asset values will change. The residence may increase in value where the investment account may be used and have a reduced value.

The use of a trust provides more flexibility, allows for the maximum assets for the surviving spouse, and allows for the assets to be divided over time. The surviving spouse receives distributions from the trust assets (either a fixed amount, all of the income, or based upon his or her need) for his or her lifetime. The children from the prior marriage then receive the assets remaining upon the death of the surviving spouse. A key to trust planning such as this is to effectively manage the investment to make the asset last for the life of the surviving spouse, and still provide some assets for the children. Also, a trustee needs to be selected that manages the trust for the benefit of all beneficiaries. A drawback to this technique is that the children from the prior marriage would not receive an inheritance until the death of the surviving spouse.

There are many, many other legal and tax issues that must be considered in this planning. Certain assets have significant tax advantages if given to the surviving spouse, and other assets cannot be given to anyone but the surviving spouse without consent. Also, in Wisconsin, the rules of Marital Property need to be considered in all estate plans for married people. Estate planning for married couples with children from a prior marriage requires careful, thoughtful planning. The two general techniques summarized in this article are often used in tandem to provide an effective comprehensive plan. The key is to establish a comprehensive plan to avoid significant divisive disputes upon the death of a spouse.

Clarifying the Tax Treatment of Gifts to Grantor Trusts in 2010 - Notice 2010-19

Back in 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). While many provisions of EGTRRA have been acutely focused on by planners since that time, one provision has received little attention until recently. Under Section 511(e) of EGTRRA, Section 2511(c) of the Internal Revenue Code was added and provides that for transfers between December 31, 2009 and January 1, 2011, except as provided in the regulations, a transfer in trust shall be treated as a transfer of property by gift unless the trust is a grantor trust.

As 2010 approached, planners began to wring their hands over what this provision means: (1) does it make incomplete gifts to non-grantor trusts complete; (2) does it make completed gifts to grantor trusts incomplete or (3) both? In Notice 2010-19, the IRS confirmed that it is the former, but not the latter. So planners can breathe easier knowing that completed gifts to grantor trusts are still an effective planning technique in 2010.

Carl D. Holborn Speaks at Corporate Casual on Estate Tax

Attorney Carl D. Holborn gave a presentation on the status of the Federal Estate Tax at the Corporate Casual meeting on February 23rd at the Milwaukee Bar Center. The presentation gave a summary of the mechanics of the tax, a history of the tax, the current status of the tax, and commentary on what might happen in the future. The Federal Estate Tax has been temporarily repealed, but returns in 2011 with a low exemption of $1.00 million. There is much speculation and uncertainty about what Congress will do which makes estate planning very uncertain.

Corporate Casual is a group of bankers, accountants and lawyers who meet on a monthly basis to network and exchange ideas. To learn more about Corporate Casual go to corporatecasual.org.

Legislation Moving Forward to Make Roth Conversions Viable in Wisconsin

The Wisconsin State Senate unanimously approved a bill to allow residents of all income levels to convert a Traditional IRA into a Roth IRA without penalty. The Legislature's Joint Finance Committee also approved the measure and the State Assembly will vote on the bill soon. This legislation has been strongly encouraged by financial and tax advisors because it makes Wisconsin tax law consistent with the federal law.

If this legislation becomes law, Wisconsin residents of all income levels can take advantage of converting a Traditional IRA into a Roth IRA. Prior to 2010, individuals with adjusted gross income in excess of $100,000 could not do such a conversion. Effective 2010, the federal legislation changed, but Wisconsin was stuck under the prior rules. The advantage that a Roth IRA has over a Traditional IRA is that the funds may be withdrawn income tax free and there are no required minimum distributions for an account owner. However, any taxpayer who does convert a Traditional IRA to a Roth IRA must pay income tax on the amount converted. There are many potential planning techniques that may help to minimize this tax.

Should you have any questions regarding Roth IRA's contact Carl D. Holborn at carl.holborn@www.wilaw.com.

Inherited Retirment Funds are not Creditor Exempt

Chapter 815 of the Wisconsin Statutes provides that certain personal assets are exempt from judgment creditors, and these exemptions can be claimed by individuals when they file federal bankruptcy. Likewise, the federal Bankruptcy Code [11 U.S.C. Section 522(d)] also provides an alternative set of exemptions that the individual can claim instead of using the Wisconsin set. Both sets generally provide for the right of individuals to retain their retirement funds (subject to some limitations) exempt from their creditors in bankruptcy. Section 815.18(3)(j), Stat.; 11 U.S.C. Section 522(d)(12).

There has been a recent local decision, however, denying such exempt status to an inherited IRA (whether originally-formed as an IRA, or a Rollover IRA set up when the decedent withdrew from a company-sponsored retirement plan) under the Wisconsin exemptions. In re Kirchen, Bankr. E.D. Wis. Case No. 04-29434. The bankruptcy trustee in that case successfully established that inherited retirement funds did not meet the requirement under Chapter 815 that the account be a fund for the retirement of the owning debtor, and therefore was not exempt. He directed the IRA issuer to pay out the funds to him to distribute to Kirchen's creditors.

Common definitive language under the Wisconsin law ("on account of … age") is a similar element needed for qualifying such account under the federal exemption set, so undoubtedly a similar ruling will occur if the claim of exemption of an inherited account is presented to local bankruptcy courts under that set. By extension, inherited pension funds (including 401k's) are also at risk.

While under our Wisconsin marital property law, an inherited IRA or retirement fund would not be eligible to collection efforts of many creditors of the other spouse, it is still liable for debts incurred in support of the marriage (if all other assets have been exhausted) and for the liabilities of the recipient spouse. These positions may be overruled by higher courts, but for now, they pose a problem that might be avoided by planning steps that a prudent recipient of an inherited retirement funds can take. For more information and to discuss such planning steps, contact Russell C. Brannen, Jr.