HUNTON& WILLIAMS

Estate Planning Alert

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Gifting in 2012: Now or Never?

Currently Americans can give $5,120,000 to anyone without paying gift taxes, less earlier taxable gifts. That amount drops to $1,000,000 on January 1, 2013, unless the law changes. If you want to make large gifts in a tax efficient manner it may be "now or never."

While no one (including probably Congress) knows how the estate and gift tax laws will change after 2012, most estates professionals expect the exemption from the gift tax to drop from the current high level. Also expected is an estate tax with potentially higher rates and lower exemptions, though the debate on the ultimate estate and gift tax is far from settled. (The current administration supports a $3,500,000 estate tax exemption equivalent and $1,000,000 for gift taxes.) So what should you do?

First, if you do not anticipate making large gifts, say over $1,000,000 (or $2,000,000 for a couple)–either due to a need for assets or an anticipation that the estate tax will not be significant for you or a belief that gifts are not appropriate for your family–then you don't need to read any further. Also if you can satisfy your gifting desires using the $13,000 annual exclusion or direct payment of medical and tuition then the exemption level may not matter. But if you are considering at any time making large gifts—to help family or to reduce estate taxes—now is the time to act.

The simplest way to use the gift tax exemption is to make a direct gift to a recipient—either cash, securities or other property. If outright giving doesn't seem to be the right approach, because the recipient is too young or might not use properly the large gift, you could gift to a trust customized to what you really want for the beneficiary and the gift.

Many clients have reservations about whether they can afford to make such a large transfer. For these clients consideration should be given to making a gift in trust for their spouse. This type of trust is being referred to as a "spousal access trust." The donor spouse cannot be a beneficiary of such a trust, and no property owned by the beneficiary spouse can be contributed to the trust. The terms of the trust can be custom designed, and could include not only the donee spouse as a beneficiary (typically the preferred beneficiary), but also the children, and even more remote descendants. This allows the donor spouse to part with the full exclusionary amount, but there will be access to that amount to provide for the donee spouse for life.

There are also ways to leverage the gift tax exemption—i.e., gift $5,120,000 but remove even greater amounts of assets from your estate. Careful consideration of those other techniques could save significant taxes for your family.

As one example you could give assets to a Grantor Retained Annuity Trust (GRAT) and retain a defined income interest from those assets for a term—shifting the excess growth and appreciation to your beneficiaries. (Certain legislative proposals limit some planning options on GRATs, but do not eliminate their usefulness under the right circumstances.) A similar gift can be done with a personal residence gifted to a Qualified Personal Residence Trust (QPRT), allowing you to live in the residence for a fixed term but having its value fixed for transfer tax purposes.

Gifts also can involve partial interests in property or family partnerships or LLCs, approaches designed to divide ownership of the property, to allow some discount on the property value. Other gifts could be a combination of a gift and a loan—particularly useful now with the low interest rates.

In addition to the high exemption, many assets are still depressed in value due to the recent economic turmoil—so gifting them might afford extra leverage.

A few caveats: Tax-wise, gifts are generally advantageous as they shift assets to the donee and let the appreciation grow in the donee's hands without further transfer taxes. Mathematically, it may even be advisable to pay gift taxes. But gifted assets do take a carryover basis, so there needs to be some consideration of that issue. Also assets can drop in value, rendering the gift less valuable. These caveats are part of a carefully developed gifting plan, and should be dealt with as needed. Another caveat is something estates professionals call "clawback"—i.e., if the exemption drops and you have used it, can the IRS claw the usage back? Possibly, but most estates professionals doubt that will happen.

The mechanics of gifting can vary based on individual needs and desires. But the one almost certainty is that failing to gift the full exemption amount in 2012 may waste a unique opportunity in the tax laws.

It may well be "now or never."

Tweeting from Beyond: What Happens to Your Digital Assets When You are Gone?

Most of us have a digital life, and for many of us that life is significant--either economically or emotionally. Have you ever considered what happens to your digital life if you die or are otherwise unable to control your digital world? Probably not, or at least no more than you considered the agreement when you opened your digital accounts. Remember that—"I accept"—Click—you signed the contract that governs that digital account.

What is your digital life? It is your iphone, ipad, personal computer, business computer, personal email, business email, Blackberry, Facebook page, Twitter account, Linkedin account, Nook, Kindle, ipod, PayPal account, etc. And a lot of other things you probably don't remember and others that haven't been created yet. It also might be how you link to your bank accounts, investment accounts, beneficiary designation providers and others. Suffice it to say, with each passing year more of your life goes digital and in increasingly complex ways. A lot of your life is lived in the clouds these days.

What happens to your digital life when you die? For now, the law is undeveloped. Most of the estates and property laws go back hundreds of years, long before digital life, and yet those old legal concepts are now trying to deal with the digital today. A few examples:.

First, your will probably leaves your tangible personal property to someone—perhaps a spouse. That currently means your spouse gets your computer. But your computer houses many digital items, including perhaps family photographs. It also is probably the direct connection for your personal email. Your email is the access point to many of your other accounts. Even accounts that are passworded often cooperate with your email to provide or change passwords. Suddenly, your spouse with your computer may have practically unfettered access to a lot of your digital life. That may be fine, BUT it may not be. What if there are items in your digital world that you don't want your spouse accessing—we will leave that to your imagination. AND, maybe your spouse doesn't get your computer, but only one of your three children does.

Additionally, your executor needs access to your digital accounts to know what you have and how to properly manage those accounts as part of your estate administration. What if your executor is not your spouse who has the computer? Or what if your executor is not digitally literate? Suddenly your digital life, some of which is necessary to preserve your estate, may be out of reach.

And what about email—your business partners may need those emails, but depending on the terms of service when you did that "Click" to set up the account, your email may be deleted at your death or rendered inaccessible.

The point, of course, is you need to estate plan for your digital assets. As part of your estate planning, you should think about who should receive your digital assets and what powers they should have concerning them. Also your executor needs the power to deal with your digital beyond—at least as well as the executor can have power with existing law. You also need to have someone competent to deal with your digital assets. For example, you could give a digital "executor" the legal ability to deal with your digital assets (yet knowing your original digital asset or account contracts may limit the powers).

To deal efficiently with your digital beyond you should create an inventory of digital assets, their access points, their functions and importantly their passwords. You need to keep this inventory up-to-date. There are even services available online now that will help fill this role for you.

Also, while you are alive, you should have an agent, under a power of attorney, able to access your digital world and manipulate your digital assets as needed. A durable power of attorney, including digital powers, might help there. The inventory of assets could be invaluable.

Your digital assets will survive you. You need to keep your digital life organized to help your family deal with those assets once you cannot do so. You also need to provide legal power to handle appropriately those assets to your executor, agents, and even heirs.

Finally, when you open a digital account, you need to think about the terms of those service agreements to determine if you really want to click "Accept," or at least how to handle them if you do "Accept".

Estate Planning in 2012: Something Old and Something New

The estate tax laws continue their roller coaster ride in 2012 and beyond. What are the basic rules–old and new–and what can you do with them during this time of continuing uncertainty?

Some of the basic estate tax rules are the same: property still passes tax free to a U.S. citizen spouse so long as it goes outright or in certain types of trusts. Also, everyone has an exemption from the estate tax which is currently $5,120,000, but absent legislative action drops to $1,000,000 on January 1, 2013.

Given this volatile exemption pattern, one important point in estate planning is flexibility—to the extent you can, to make sure your planning fundamentally works at any exemption level.

Further, basic estate planning often takes advantage of the martial deduction to delay taxes until the death of the second of a married couple and orchestrates the passage of property to take advantage of the exemption of both spouses. Typically, that planning has been done through use of what is known as a credit shelter or bypass trust (often called a Family Trust). In other words, at the death of the first spouse property passes in a way that uses the first spouse's exemption but is "available" to the second spouse. At the death of the second spouse her exemption can also be used. This staging effectively doubles the exemption. With this planning, under current law a couple can leave $10,240,000 without federal estate taxes.

One problem with planning to use both exemptions is that the first spouse to die has to have sufficient assets in his name to pass in a way to use his exemption. This tends to be less of a problem in community property states. Staging assets can be difficult, partly because no one knows which spouse will die first and also due to some of the income tax advantages of leaving assets to a surviving spouse. For example, it is often very advantageous to leave an IRA to a surviving spouse who can then roll it to her own IRA to delay the income tax.

A recent change in the estate tax laws does ease some of the planning for use of the exemptions of both spouses. This new feature is referred to as "portability", and means that the first deceased spouse's exemption can simply pass to the second spouse so long as the rules are followed and nothing disrupts that passage. In the simplest situation, under current law where a couple has, for example, $9,000,000, the first deceased spouse can leave everything to the surviving spouse, and the surviving spouse in 2012 can receive their $5,120,000 exemption which then allows the surviving spouse to pass the entire $9,000,000 to children without estate taxes. The result is excellent, but that does not mean it should be relied upon.

First, to have portability the first deceased spouse's estate has to file an estate tax return, even if that return is otherwise unnecessary. For a larger estate that return is not a particular burden because it is required anyway, but in many cases that return is simply unnecessary paperwork and expense. These concerns will be even more pronounced where there is a second marriage and the surviving spouse might like to receive the exemption and the executor is a child of an earlier marriage who has no interest in the estate spending money to prepare an expensive tax return to benefit the surviving spouse. In those cases, some planning upfront to require an estate tax return— while also requiring the spouse benefiting from it to pay for it—may be appropriate.

The second problem with portability is that it can be lost. The law simply won't let someone keep marrying and collecting exemptions and so a later marriage might use or lose the earlier exemption, making portability unavailable as originally planned. Planning for portability, where it matters, might take place as early as a prenuptial agreement in some cases.

But perhaps the biggest problem with portability is the same problem as with the estate tax itself. Current rules disappear at the end of 2012 and the law reverts to the law of 2001—long before portability was even considered. Thus, for a couple to rely fully on portability they both have to die before 2013—not exactly planning most people want.

Comparing portability to traditional planning with a credit shelter trust, portability comes up severly lacking. A credit shelter trust can be funded with the exemption at death—say $5,120,000, but the amount in the exempt trust at the second death may be significantly larger than $5,120,000, due to growth between funding and death. The exemption given through portability to the surviving spouse does not grow—but is frozen at the original amount. Also the credit shelter trust arrangement can use the generation skipping tax exemption of the first deceased spouse to save more taxes, but relying on portability can waste that first spouse's generation skipping tax exemption.

Many estate planners guess that portability will eventually become a permanent feature in our estate tax system, though its path to permanent during the political machinations of 2012 and the post-election period are uncertain. And, relying upon portability does not maximize potential tax savings for the family.

And while for many portability may seem a nice concept and nothing to worry too much about with a $5,120,000 exemption, the exemption is scheduled to drop to $1,000,000 in 2013. While many estate planners think (hope) it will settle in higher than that, no one is confident that it will. If the exemption stays at $1,000,000 then planning to maximize all exemptions will be critical for many Americans.

For people doing estate planning, portability may be a valueable correction for mistakes, but perhaps not a core element of their planning.

UPMIFA to the Rescue

While the market was near its lowest point in March of 2009, the North Carolina General Assembly adopted the Uniform Prudent Management of Institutional Funds Act, known as UPMIFA. Both Virginia and Texas had adopted their own versions of UPMIFA earlier. This new technical law gives increased flexibility to charities handling their endowments, permitting them better control over spending funds and more ability to alter endowment terms. These improvements for charities can also simplify the work of CPAs auditing charities or preparing IRS Forms 990 for them. Also knowledge of this new law can help charities to utilize this new law to fulfill better their charitable missions.

UPMIFA governs endowment funds, which are funds held by institutions for exclusively charitable purposes, not wholly spendable on a current basis. CPAs refer to these funds as permanently restricted, as contrasted to temporarily restricted funds such as funds a charity designates itself as an "endowment fund" for its own use. Recent changes in the accounting rules and reporting on new IRS Form 990 make these classifications critical.

UPMIFA provides standards of conduct for managing and investing institutional funds which are important for boards to consider, but also to document. But the real key of UPMIFA is its flexibility for spending endowment funds. While donor intent expressed in a gift instrument is always of paramount importance, UPMIFA makes it clear that provisions requiring use of only income or dividends (or to preserve the principal intact, or similar terms) do not control the board's ability to expend or accumulate endowment fund assets unless the donor has expressly said so by taking the funds out of UPMIFA or specifying percentage or dollar limits.

Without more express limitations, the institution can spend funds as it determines to be prudent for the purpose of the fund. In doing so, the charity must consider (1) the duration and preservation of the fund, (2) the purposes of the institution and fund, (3) general economic conditions, (4) possible effect of inflation or deflation, (5) expected total return, (6) other resources of the institution and (7) investment policy of the institution. If the charity addresses the preceding points (and preferably documents its analysis) it can spend more than the income of an endowment fund, and may spend into the original (historic) value of assets of the fund.

UPMIFA's predecessor statute limited spending to only growth/income above the original historic gift amount. That limitation froze many funds during the recession, leaving charities with strong endowments and no legal way to use them when perhaps they needed them most. As a result of the recession, all but one state have now adopted UPMIFA, allowing charities to tap their endowment resources when needed.

As important as the spending rules of UPMIFA are, the provisions to alter an endowment under UPMIFA may prove even more valuable in the long run. If a charity can demonstrate to a Superior Court and the Attorney General that the limitations in a gift instrument are unlawful, impracticable, impossible to achieve or wasteful, then the restrictions can be changed. Management and investment restrictions can be for similar reasons but also if they impair the fund or if there are circumstances the donor did not anticipate. A living donor can generally consent to release any restrictions.

For smaller funds that have been in existence for a number of years, the institution itself can modify restrictions consistent with the charitable purpose without court approval after giving notice to the Attorney General. (In North Carolina this provision applies to funds under $100,000 that have been in existence for 10 years; in Virginia funds under $50,000 for 20 years; and in Texas funds under $25,000 for 20 years. Virginia also allows non-judicial modification of any fund less than $250,000 with the Attorney General's approval.). Many charities have hundreds of tiny endowment funds left from the fundraising customs of years ago. Proper utilization of these UPMIFA change provisions could eliminate complicated record keeping and accounting for these tiny funds, through the UPMIFA modifications.That simplification could greatly assist the charity.

UPMIFA is a powerful tool allowing charities to best utilize all of their assets to fulfill their charitable missions.