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What does the new tax act mean for you, your real estate investments, and your estate plan?

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After a decade of legislation with staggered and expiring provisions, the American Taxpayer Relief Act of 2012 (ATRA) made the federal estate, gift and GST tax exemptions that were in place during 2011 and 2012 permanent, i.e. non-expiring. Individuals still have a \$5 million federal estate, gift and GST tax exemption, indexed for inflation (\$5,250,000 in 2013). However, ATRA increased the top tax rate for these taxes from 35% to 40%. Fortunately, the portability provisions that were instituted at the end of 2010 were also made permanent by ATRA. Portability gives a surviving spouse the use of the deceased spouse's unused estate tax exemption for his or her own gift and estate tax minimization planning. There have been no changes to the Massachusetts estate tax since 2003, when a separate estate tax with a \$1 million per person exemption was finalized.

The federal and state estate tax systems pose a substantial burden on real estate owners, as estate taxes must be paid within nine months of death. However, there are tax minimization and deferral techniques that can be utilized in the decedent's estate plan to mitigate these taxes. A thorough estate plan will address estate tax minimization and a host of other transition planning issues, such as business succession planning and planning to meet liquidity needs to pay debts, taxes and other obligations that can come due unexpectedly. Such a plan will create a roadmap for the family and other parties to follow in the event of an unexpected illness, death, or other disability, so that the value of the enterprise and the personal relationships of those involved are not jeopardized.

Since the combined federal and Massachusetts estate tax rates can approach 50%, and since estate taxes are due nine months from date of death, many real estate owners take advantage of lifetime transfer techniques that are designed to move the appreciation of the asset's value out of the taxable estate. This is generally done by making gifts to children and grandchildren, either outright or in trust, in such a manner that the real estate owner is satisfied that his or her own cash flow needs will continue to be met.

An example for a real estate owner who relies on the properties' cash flow but can part with the future appreciation, is a technique known as a Grantor Retained Annuity Trust (GRAT). The real estate owner transfers all or a partial interest in the real estate (or in the entity that owns the real estate) to the GRAT and retains a fixed periodic payment for a defined period of years. If the real estate owner survives the defined period, the entire value remaining in the trust at death will escape estate taxes.

A real estate owner who is comfortable parting completely with all or a partial interest in the real

estate can utilize a technique known as a Generation-Skipping Transfer Trust (GST Trust). The "skip" here refers only to estate taxes, not to skipping one's children in favor of one's grandchildren!

It is also possible to freeze the value of an asset in the taxable estate by utilizing notes that pay interest at the Applicable Federal Rate (AFR). With this technique the real estate owner sells an interest to the children and/or grandchildren, outright or to a GST Trust. The cash flow from the real estate is used to make the note payments. If the actual appreciation in the asset exceeds the AFR, that excess escapes estate taxes, while providing the owner with cash flow.

These techniques will all be more effective if partial interests are transferred utilizing valuation discounts for minority interest and lack of marketability, as well described by Randolph Glennon recently in this Journal.

In order to create liquidity to pay estate taxes on the value of any remaining real estate, business owners frequently utilize life insurance owned by an Irrevocable Life Insurance Trust ("ILIT"). One common myth is that life insurance passes free of estate taxes, in addition to passing free of income taxes. This is not the case if the insured owned any rights to, or controls over, the policy.

The above techniques include the "hot button" estate planning issues that ATRA did not address, such as abolishing valuation discounts for intra-family transfers of closely-held businesses, requiring a minimum ten year term for GRATs, and eliminating some or all of the estate planning benefits of the grantor trust rules (whereby a trust is disregarded as a separate taxpaying entity). The conspicuous absence of these revenue-raising items from ATRA creates speculation that they will be addressed in future legislation. Therefore, if you did not use some or all of your increased gift tax exemption during the last two years, now is the right time to most effectively take advantage of this planning opportunity.

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